Inside Outcomes of Insider Lending

by **Ajay Palvia**, **Jon Pogach**, and **Chiwon Yom** (FDIC)

Discussion by **Ricardo Duque Gabriel** (FRB)

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Summary

Research Question: Is insider lending driven by agency conflicts or informational advantages?

Identification Strategy:

- Exploit variation in external credit conditions leveraging state-level average loan growth as an instrument.
- Examine effectiveness of regulation by exploiting variation in regulatory scrutiny intensity around bank distress.

Data:

1. **Bank-level dataset**: Quarterly Call Reports data for U.S. banks (2005-2019).
2. **Loan-level dataset** (failed banks only): FDIC administrative data (loss-share program, 2008-2013).

Main Findings:

- Insider lending increases when external credit supply weakens.
- Insider loans do not perform worse (often better) than comparable outsider loans (at failing banks).
- Regulatory oversight reduces (risky) insider lending and mitigates agency conflicts.

Agency or Information Theory? 5 Hypotheses

#	Hypothesis		Agency	Information
1	*"The change in proportion of insider loans is not related to the lending environment (loan growth)."*	**Rejected**	No	Yes
2	*"Bank capitalization is not associated with changes in insider lending nor affects its relationship with loan growth."*	**Not Rejected**	No	Yes
3	*"Bank risk is unrelated to changes in the proportion of insider lending."*	**Not Rejected**	No	Yes
4	*"Ex-ante loan terms are comparable between insider borrowers and other borrowers."*	**Rejected**	Yes (partial)	Yes
5	*"Ex-post loan outcomes are comparable for insider borrowers relative to other borrowers conditional on loan terms."*	**Rejected**	No	Yes

Main Comments and Suggestions

1. Instrumental Variable and Identification

Issue:

- Instrument: **Average loan growth at other banks in the same state (excluding bank A)**.
- Unusually high F-statistic ($\approx 10,000$) raises concerns.
- Possible violation of exclusion restriction (instrument directly affects insider lending):
  - **Competitive interactions among insiders**: Insiders might choose insider loans strategically depending on state-wide lending conditions to maintain competitive advantage or avoid attention.
  - **Common regulatory pressure**: Strong statewide credit growth might directly trigger regulatory scrutiny or market discipline across all banks in the region, affecting insider lending directly through tightened or relaxed regulatory monitoring.

Suggestions for alternative instruments:

- **Bank Mergers and Acquisitions in Local Markets** affecting lending competition (Erel, 2011)
- **Bank's Exposure to Natural Disasters** causing exogenous lending shocks (Cortés and Strahan, 2017)
- In addition, explicitly justify the validity of the exclusion restriction.

2. Loan-Level Analysis

Issue:

- Only **30 banks** with insider lending **(181 insider loans)**, but analysis uses loans from **all 219 banks** as controls.
- Loans from banks without insider lending might differ systematically, potentially biasing results.
- Number of observations in Table 11 varies across specifications, not allowing direct comparisons.

Suggestions for improvement:

- Consistently employ **Propensity Score Matching** to select comparable loans from other banks.
- Use matched loans explicitly across *all* loan-level analyses (consistency).
- Alternatively, demonstrate similarity of loan characteristics between insider-loan banks and control banks.
- Ensure consistent, **balanced samples** across specifications to clearly test different hypotheses.

3. Direct Testing of Insider Lending and Bank Failures

Issue:

- **Methodological concerns**: using OLS to regress binary outcomes (e.g., loan delinquency dummy) on binary explanatory variables might be problematic (Table 11).
- The paper currently lacks a direct test of whether insider lending ratios explicitly predict bank failures or bank distress (Table 10).

Suggestions for improvement:

- Consider appropriate binary-outcome models explicitly (e.g., Probit or Logit).
- Explicitly test the predictive power of insider lending on bank failures which would substantially enhance policy relevance.
- Possibly following Correia, Luck, and Verner (2025) for methodology on predicting bank failure.

Minor Comments

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- Ensure consistent definition and notation for insider lending (ratios, changes, dummy variables).
- Explain clearly why insider lending is measured as ratios instead of log growth like bank loans.
- Clarify explicitly reference categories in Table 11 regressions (CRE, C&I, Consumer vs. other).
- List control variables explicitly and consistently across specifications (table notes).
- Consider plotting Figure 1a with a fixed sample composition: clarify break post-2012.
- Reconsider Hypothesis placement: present before introductory text to enhance readability.
- Explain clearly if/when differences in the number of observations across tables affect hypothesis interpretations.
- Table 2: column with t-test needed.
- Table 14: Missing variable Term.
- Table 15: Wrong notation in row 4; it should be $\Delta CAMELS_{t-1,t}$.

Thank you!