



Hard and Soft Information: Implications for Banking and Finance Research

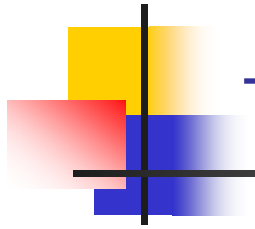
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Mitchell A. Petersen
Northwestern University and NBER

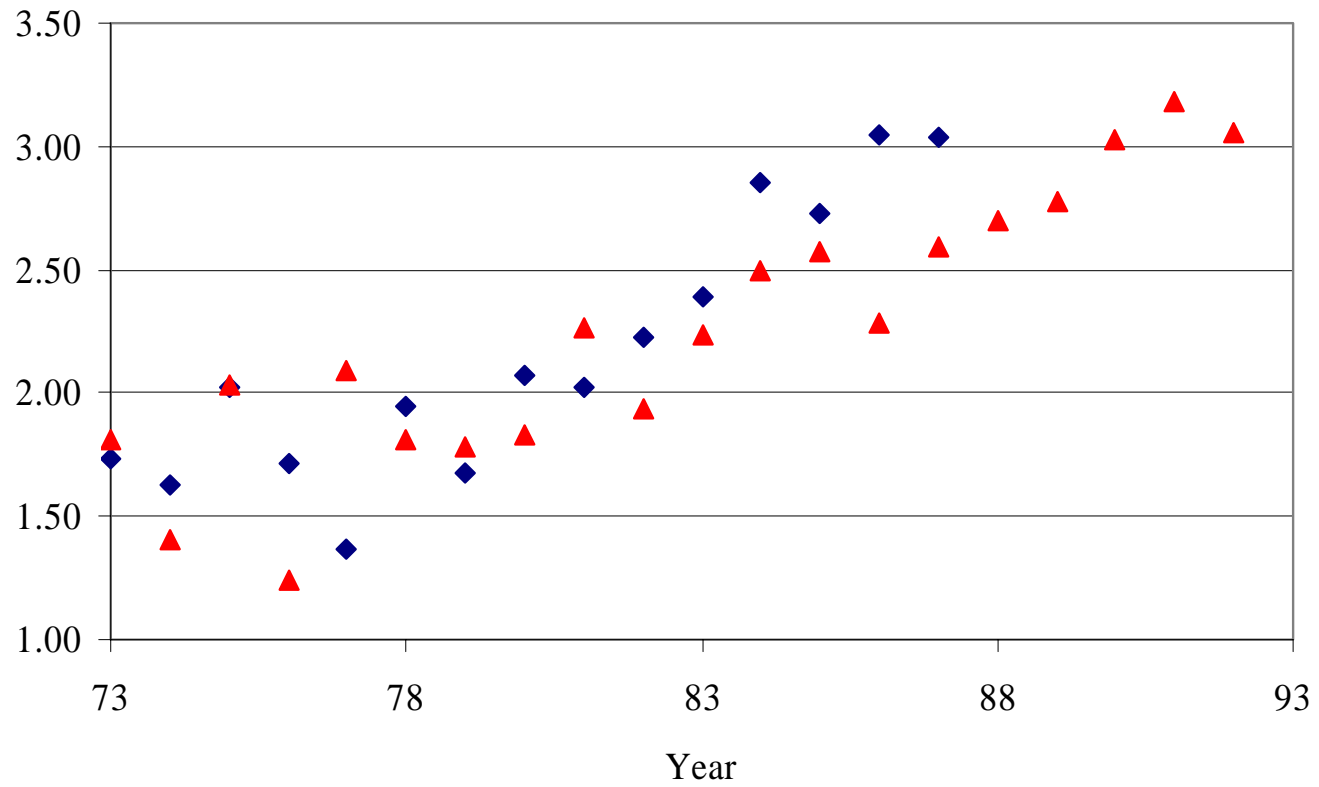


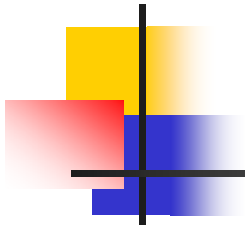
Evolution of Small Loan Market

- Consumer Finance History
 - How did middle America save and invest: Examines the development of the credit card market, the mortgage market, discount brokers, and mutual funds
 - 1950-70s: The market was local & personal
 - Today: The market became national, competitive, & cheaper
- Small Business vs. Individual Borrowing
 - Academic's view (Finance & Sociology)
 - Practitioner's (banker's) view
- Question: What forces prompted this change?

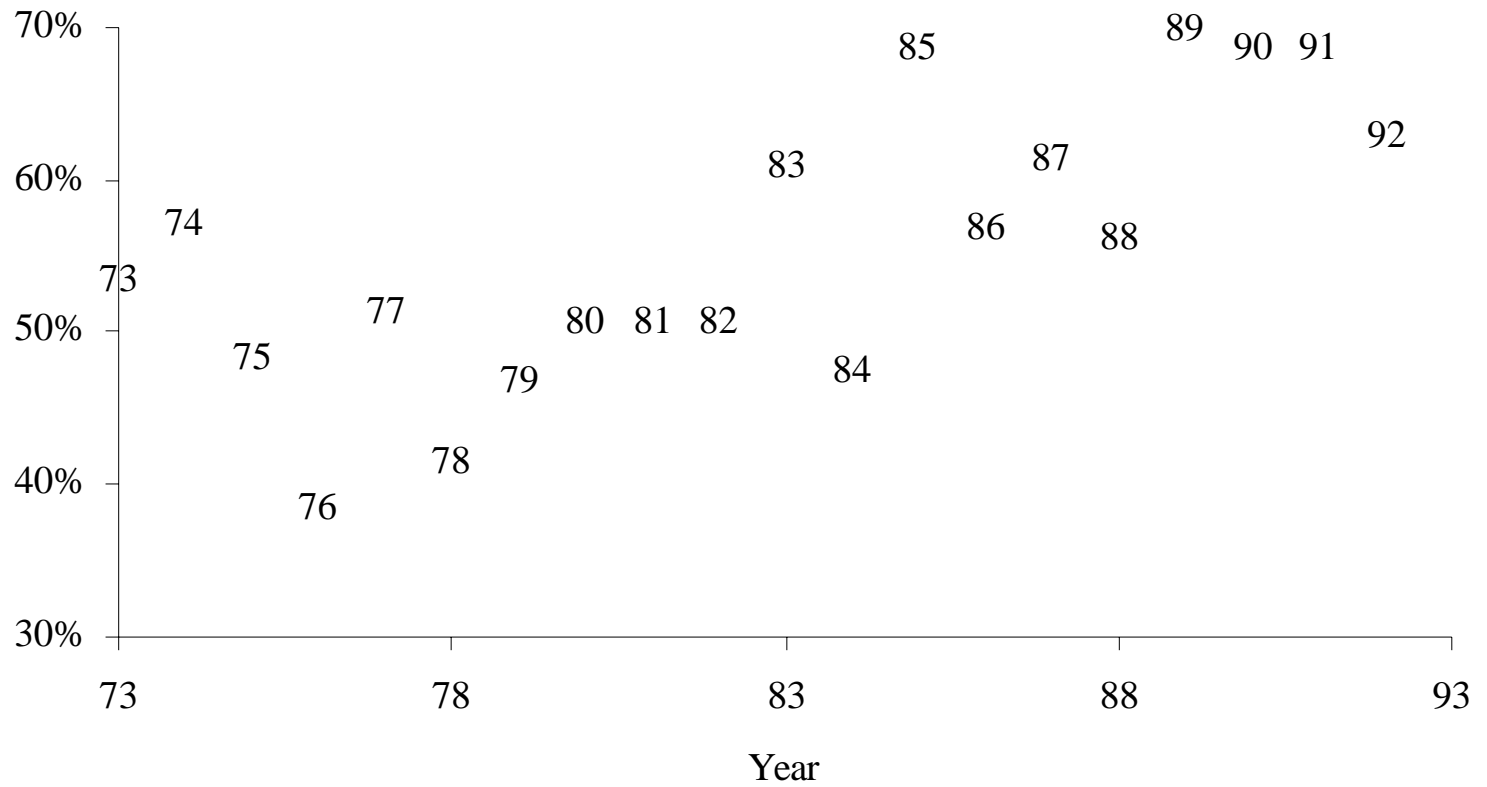


The Facts: Lenders are More Distant ...

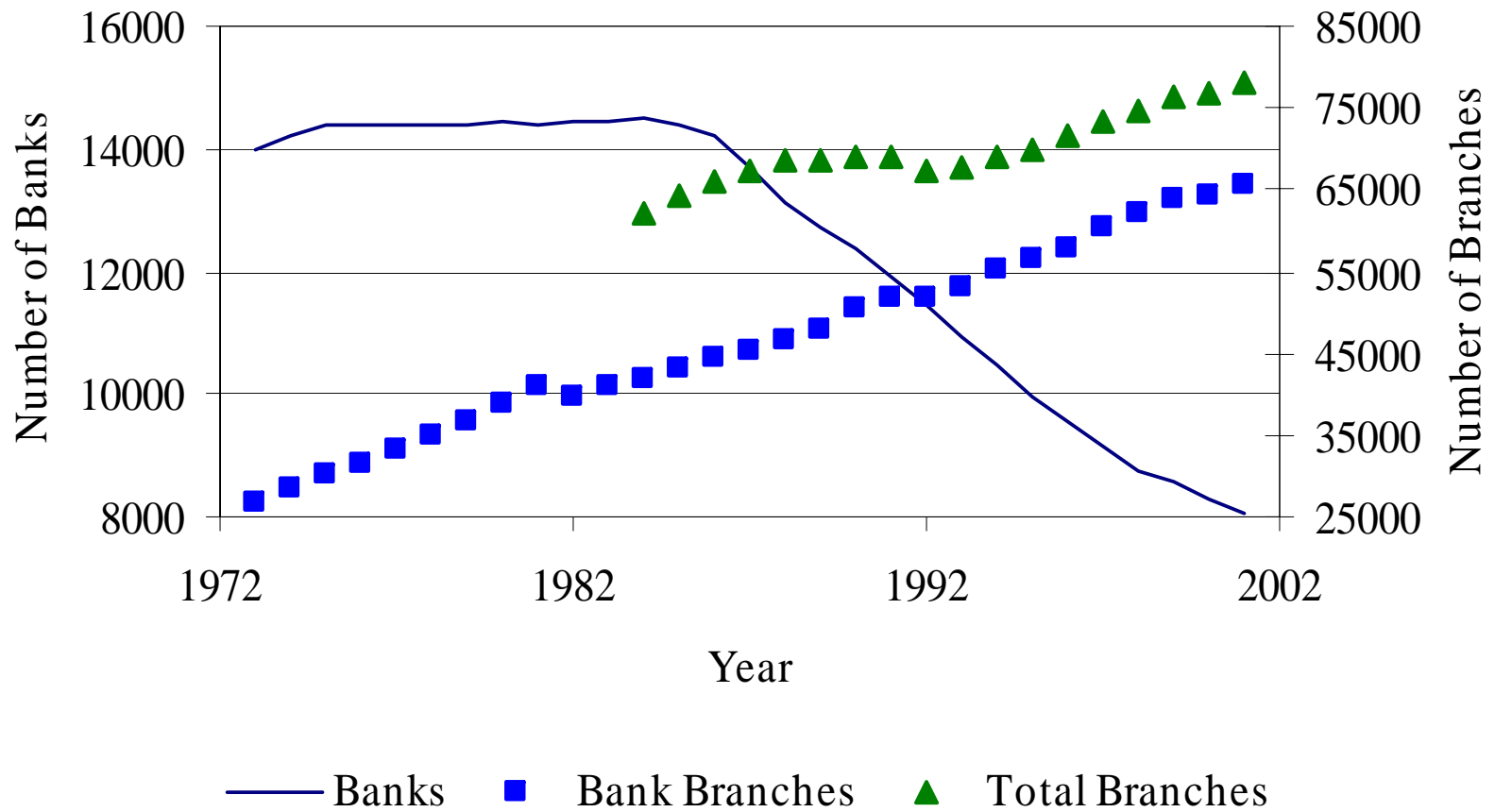




& More Impersonal



Banking Consolidation





Incentives and Information Type

- Firm Size and Information Type Matter
- Simple Intuition (Stein, 2002)
 - Small bank
 - Loan officer is owner
 - Short distance
 - Large (multi-divisional) bank
 - Capital allocation separate from investment decision
 - Reduced incentives: Soft information
 - Increased incentives: Hard information
- Empirical Implications
 - Large banks: Less efficient at making relationship loans
 - Growing bank size may lead to credit rationing



Empirical Test:

The Importance of Information Type

- Large Banks are More Impersonal
- Importance of Lending Relationships
 - Lending relationships relax credit constraints (PR, 1994)
 - Lending relationships are weaker, shorter, and less important for large banks
- Bank Size and Credit Rationing
 - Ordinary least squares: Static Results
 - Instrumental variables: Dynamic Results
- Interpreting the Stein Model
 - Cost of passing information up the hierarchy
 - Defining soft versus hard information



Characteristics of Soft & Hard Information

- Collection and Storage
 - Quantifiable: Numbers versus text
 - Collection can be impersonal
 - Data base storage and retrieval easy
- Comparability of Information
 - Meaning is independent of person or collection.
 - “Hard information.. (is when) everyone agrees (on its meaning. ... Honest disagreements arise when two people perfectly observe information yet interpret this information differently (i.e. soft information).”
Kirschenheiter, 2004
 - Essential for transmitting the information
- Delegation of Collection & Decision Making
 - Knowing what you are looking for
 - Knowing what is important



Pros and Cons of Hard Information

- Lower Transactions Costs
 - Greater economies of scale
 - Standardization leads to a wider market
- Durability of Information



Pros and Cons of Hard Information (cont)

- Lost Information
 - Compression means smaller bandwidth
 - Avoiding information overload
 - What information is lost
 - Inertia and bubbles (Hirshleifer & Welch, 2002)
- Gaming the System
 - Manipulation of reported information
 - Fuzzy method of establishing bond ratings
 - Importance of discreteness?



Implications for Corporate Finance & Financial Research

- Market and Institutional Reaction to Information Technology
- Attempts to harden information
 - Evolution of credit scores: Dun & Bradstreet
 - Can soft information be hard information?
 - E-mail
 - Why are firms different than people?



Implications for Corporate Finance & Financial Research (cont)

- Examples of Research
 - Liberti, 2004, "Initiative, Incentives and Soft Information"
 - Carruthers and Cohen, 2001 "Predicting Failure but Failing to Predict: A Sociology of Knowledge of Credit Rating in post-bellum America"
 - Goetzmann, Pons-Sanz, & Ravid, 2004, "Soft Information, Hard Sell: The Role of Soft Information in the Pricing"
 - Butler, 2004 "Distance Still Matters: Evidence from Municipal Bond Underwriting"
 - Kirschenheiter, 2004, "Representational Faithfulness in Accounting Information: A Model of Hard Information"



Implications for Corporate Finance & Financial Research (cont)

- Changing the Method of Research
 - Current approach to corporate finance: the numbers
 - Origins of CRSP
 - Expanding the data which is available



Conclusions

- Soft & Hard Information are Important Characteristics of the Environment
- Information Type Helps Explain Market and Institutional Design
- There is Still Much Work to Be Done