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Commentary

Strategic Default and Optimal Audit Resources with Costly State Verification

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DESCRIPTION

Create a model where the borrower's capacity to repay a loan is private information that can only be confirmed by the bank under specific circumstances at a cost that may be recovered from the borrower if it provided false information. The bank will make the most of the resources it invests in this auditing of borrowers and the equilibrium that results is then described. In equilibrium, it is demonstrated that a sizable portion of businesses strategically fail, but the majority are discovered by auditing. Additionally, banks have low failure rates. Finally, extensions that would restrict banks' liability and partially reimburse auditing expenses as well as the fees incurred by borrowers as punishment are explored. Banks evaluate the creditworthiness of borrowers when making loans to businesses to determine whether a loan is given. The likelihood that the borrower won't be able to repay the loan because the firm fails is a key component of this assessment. The loan's repayment, however, will also be based on the firm's or its management's willingness to fulfil its responsibilities, in addition to the performance of the underlying investments the company makes. Even though they could afford to pay back the loan, management may take steps to hide the true health of the business in order to avoid payments and go into default. The term "strategic default" refers to such behavior. It is typical to believe that if a business defaults, the bank will be able to confirm it by appointing auditors. With limited resources, the bank will typically be unable to audit every defaulting company because auditors will be expensive for the bank. As a result, borrowers can decide to coordinate their actions in order to deplete the bank's resources and evade detection.

Figure out the best course of action for a corporation to deliberately fail while still allocating resources to an audit by a bank. This enables evaluation of both the cooperation of borrowers as well as the reaction of the banks to this coordination. The model expands on earlier research by assuming that audit resources are totally endogenously determined and that the best audit resources are determined by the bank.

The strategic default frequently focuses on the trade-off between the advantages of deferring loan repayment and potential disadvantages, like the inability to secure more loans for successful ventures. There is empirical support for strategic default in an experimental environment introduced the concept of a borrower run, wherein a bank's bankruptcy as a result of defaulting borrowers removes the advantages of getting future loans, potentially leading to a coordinated failure to repay. These models prevent strategic default when the advantages of debt repayment in the future outweigh the cost of payback.

Any such potential costs of strategic default will be disregarded in favor of a model that only considers incentives over a particular time period. Show how loan agreements can be enforced through the legal system in a different way, with a particular emphasis on how collateral can be used to offset any losses caused by insufficient contract enforcement. Here, the auditing of borrowers is replaced by the court system.

With the limited resources set aside by banks to audit defaulting companies, some companies will be able to avoid detection; the more defaults there are, the less likely it is that they will be discovered. This is demonstrated in a model in which banks use expensive audits. Borrowers default as they anticipate other borrowers to default. Assume that if a firm is audited, the surplus value will be taken in its entirety and that, in all other cases, the company will only keep a portion of the surplus. However, rather than being the bank's profit-maximizing choice, resource auditing is decided by a social planner. They demonstrate how strategic default occurs in an equilibrium.

The issue that is thus absent from the literature is how banks would decide on their audit resources in the best way if they did not know the degree of strategic default and at the same time, companies do not know the extent of audit resources committed. With the model described hope to fill this vacuum in the literature. A scenario where businesses want to maximize

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predicted earnings through strategic defaults while banks also do the same by allocating resources for audits. Subject to resource constraints, audits are expected to be conducted for every defaulting enterprise, and they reliably identify any strategic default.