Bank Monitoring and Liquidity in the Secondary Market for Loans*

Yu Jin

Shanghai Univeristy of Finance and Economics

Abstract

We study transaction loans and traditional-relationship loans in a dynamic lending model. Since transaction loans are easer to resell, a bank's payoff from transaction lending over relationship lending is increasing in the secondary market loan liquidity. The relative payoff is also increasing in the proportion of banks that choose transaction lending because lower quality borrowers prefer transaction lenders, who monitor them less. When liquidity rises above a given threshold, all banks switch to transaction lending. However, greater liquidity also increases economy-wide default risk since banks reduce monitoring efforts. If the effect of defaulting is strong enough, securitization can lower welfare.

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