Competition between Arm's Length and Relational Lenders: Who Wins the Contest?

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Overview

- **Questions:**
  - What is the effect of increased competition on incumbent bank lending?
  - How does this effect depend on lending "technology" used by incumbents and entrants?
  - Here: users of soft info ("relational") vs. non-users ("arm-length")
- **Motivation:** important Q given changes in competition *and* lending technology
- **Approach:** Analyze incumbents' lending response to new branch openings
- **Findings:**
  - Loan size decreases, but number of loans is unchanged
  - Loan size falls *more* when entrant is a relationship lender
  - Arms-length entrants only crowd out other arms-length lenders

Comment 1: Mechanisms

- Default responses can help distinguish between mechanism

- Found entrance of relational lenders *increases* defaults among arms-length incumbents

- **Possible mechanisms:**
  - "Moral hazard": borrow more $\Rightarrow$ default more
  - Firm competition: borrow more $\Rightarrow$ beat competitors
  - Adverse selection: cream-skim best borrowers

"Moral Hazard" vs. Firm Competition

- "Moral hazard": borrow more $\Rightarrow$ default more
  - Prediction: defaults rise among firms with increased credit

- Firm competition: competitive pressure $\Rightarrow$ default more
  - Prediction: defaults rise among firms without increased credit

- **Importance:**
  - Learning about the effects of bank competition *or* firm competition? (exclusion restriction)
  - Moral hazard vs. adverse selection matters for design of default-minimizing regulations

Adverse Selection (Cream-Skimming)

- **Cream-Skimming:** using info advantage to "steal" the "best" borrowers
- **Prediction:** incumbents lend less to low-default firms when entrant is relational
- **Importance:** can exacerbate adverse selection
    - Potentially important competitive implication of FinTech
    - E.g. Bachas (2019) for student loans

Comment 2: Identification

- Paper measures competition as proximity to entrant
- **Concern:** unobs. factor drives both incumbent lending and branch location choice
  - Sign of bias not obvious
- Understate lending reduction if branches open where firms are booming and borrowing more
- Overstate lending reduction if branches open where
  - Banks expect other lenders to scale down
  - Firms are booming and relying less on debt
  - Firms are booming and arms length are reallocating to large firms
- **Test:** look for pre-trends in incumbent lending – diff-in-diff style plot would be great!

Conclusion

- Great paper! Important new angle on bank competition
- Sheds light on impact of two important trends: financial technology and competition
- Can give deeper interpretation by exploring mechanisms