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# Deposit Competition and Loan Markets\*

Stefan Arping<sup>†</sup>

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## Abstract

Less-intense competition for deposits, by mitigating banks' incentive to take excessive risks, is traditionally believed to lead to lower non-performing loan (NPL) ratios and more-stable banks. This paper revisits this proposition in a model with borrower moral hazard in which banks' NPL ratios depend endogenously on their loan pricing. In relatively uncompetitive loan markets, less-fierce competition for deposits (i.e., lower deposit rates) leads to lower loan rates and, thus, safer loans. In more-competitive markets, the *opposite* can occur: As banks' deposit-repayment burdens decline, they become less eager to risk-shift; this softens competition for risky loans, leading to higher loan rates and, ultimately, riskier loans. Overall, the model predicts a hump-shaped relationship between banks' pricing power in deposit markets and their NPL ratios.

*Keywords:* Bank Competition; Loan Pricing; Financial Stability

*JEL Classification:* G2, G3, L1, L3

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