Accepted Manuscript

Deposit Competition and Loan Markets

Stefan Arping

PII: S0378-4266(17)30084-5
DOI: 10.1016/j.jbankfin.2017.04.006
Reference: JBF 5130

To appear in: *Journal of Banking and Finance*

Received date: 12 April 2016
Revised date: 6 December 2016
Accepted date: 7 April 2017

Please cite this article as: Stefan Arping, Deposit Competition and Loan Markets, *Journal of Banking and Finance* (2017), doi: 10.1016/j.jbankfin.2017.04.006

Deposit Competition and Loan Markets *

Stefan Arping †

December 2016

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

*I thank two anonymous referees, Carol Alexander (the Editor), Arnoud Boot, Gabriella Chiesa, Torsten Jochem, Yoshiaki Ogura, Steven Ongena, Klaus Schaeck, Xavier Vives, and Tanju Yorulmazer, as well as seminar audiences at University of Amsterdam, VU University Amsterdam, Gerzensee, and FIRS and EFA conferences for very helpful comments and suggestions.

†University of Amsterdam, Amsterdam Business School, Finance Group, Plantage Muidergracht 11, 1018 TV Amsterdam, The Netherlands. E-mail: s.r.arping@uva.nl. Phone: +31-20-5254152