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ORIGINAL ARTICLE

Do bad borrowers hurt good borrowers? A model of biased banking competition

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Abstract

This paper explores a two-bank model in which, first, one bank correctly estimates the probability of low-quality loan repayment while the other overestimates it, and second, both banks have identical convex costs when granting loans. In this context of optimistically biased banking competition, we show how the unbiased bank follows the biased competitor as long as the bias of the latter is not too large. This would favour bad borrowers, who get better credit conditions at the expense of good borrowers. As a consequence, the presence of a biased bank increases welfare as long as the expected default rate is sufficiently high. Contrariwise, in subprime markets, biased banking competition would be socially harmful.

Keywords Overoptimism · Convex costs · Externalities · Crowding-out · Credit financing

JEL classification G21 · D62 · G02