Andreas Krause

Chapter 11.3.1

Adverse selection and competition

Key assumptions

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- $\Pi_B = \pi(1 + r_L)\, L$

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- Banks not lending to a company do not know its type and will assume loans are repaid with the average success rate, and they pay their depositors
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- $\hat{\Pi}_B^i = \pi_i \left(1 + \hat{r}_L^i\right) L - (1 + r_D)\, L - C$

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- Competition erodes the profits not arising from their informational advantage

$\Rightarrow \hat{\hat{\Pi}}_B^i = (1 - \theta)\left(\frac{\pi_i}{\pi}\Pi_B - C\right)$

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Feasibility of relationship banking

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Andreas Krause
Department of Economics
University of Bath
Claverton Down
Bath BA2 7AY
United Kingdom

E-mail: mnsak@bath.ac.uk