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## Agency Cost of Debt and Lending Market Competition: Is there a Relationship?

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# CE Sifo *Working Paper Series*

## AGENCY COST OF DEBT AND LENDING MARKET COMPETITION: IS THERE A RELATIONSHIP?

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Working Paper No. 274

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## AGENCY COST OF DEBT AND LENDING MARKET COMPETITION: IS THERE A RELATIONSHIP?

### Abstract

We address the question of how lending market competition, measured by the bargaining power of banks, affects the agency costs of debt finance. It is shown that intensified lending market competition will lead to lower lending rates and investment return distributions which are shifted towards lower, but less risky returns. Consequently, it follows that increased lending market competition will reduce the agency cost of debt financing. Hence, our analysis does not lend support to the commonly held view that there would be a trade-off between more intensive lending market competition and higher agency costs of debt finance.

Keywords: Bank competition, agency cost of debt

JEL Classification: G21, G34, L11

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## **1. Introduction**

A dominant approach in modern research on credit markets starts from recognizing asymmetric information as an important source of fundamental imperfections in these markets. The magnitude of these imperfections determines how efficiently the credit market performs as a channel whereby projects generating high (social or private) returns are realized and whereby low-return projects are denied financing. Debt contracts incorporate a conflict of interest between lenders and borrowers and therefore this type of financial contracts forms the basis for an agency relationship between debtholders and projectholders. This contractual relationship causes agency costs because the investors cannot typically commit themselves to credibly act in the interest of lenders. Agency costs generated by debt financing imply that project selection will be distorted relative to the first-best benchmark of maximizing the expected project surplus in a world where agency-based incentive problems could be eliminated.

For more than two decades an extensive literature in financial economics has investigated various aspects of the agency costs of debt with a particular focus on exploring the implications of these agency costs for the optimal financial structure of firms (see Harris and Raviv (1991) for a comprehensive survey). Much less attention, however, has been paid to the fundamental issue of how competition in the lending market will impact on the agency costs of debt. In the present study we will systematically address precisely this issue by directly posing the following questions. Will an increased degree of competition between lenders promote efficiency of credit markets by reducing the agency costs of debt and will it, as is frequently argued, lead to increased credit market fragility in the sense of increasing the equilibrium default risks? Answers to these questions are central for all attempts to evaluate the potential welfare gains from the ongoing worldwide process of financial integration. For example, within the framework of the

European Union one of the main goals of promoting financial integration, the process of which has culminated with a single banking license and common numeraire in the EMU-countries from the beginning of 1999, was to encourage competition in banking. This policy development can be seen in light of a number of influential studies such as the so-called Cecchini report (Price, Waterhouse, 1988) or the European Commission Study (Emerson (1992)), which *inter alia* emphasize the benefits of increased competition.

An important class of recent microeconomic studies has focused on the general issue of whether external competition fosters internal firm efficiency. Holmström (1982), Nalebuff and Stiglitz (1983), Hart (1983) and Scharfstein (1988) offer models in which increased competition will promote internal firm efficiency for the reason that competition generates valuable information (making, for example, relative performance evaluation possible) which can improve the precision with which an agent can be evaluated. It is shown in other studies how increased competition in imperfectly competitive product markets will affect the demand facing an individual firm, and thereby the incentives of the professional management to invest effort into cost reduction. Martin (1991) characterizes circumstances under which an increase in the number of competitors tends to reduce managerial effort, while Horn, Lang and Lundgren (1994) find a negative relationship between effort incentives and the competitiveness of the product market in the duopoly case. Schmidt (1997) emphasizes still another potentially positive impact of external competition on firm efficiency by exhibiting how more intense competition may increase the threat of bankruptcy, so that the optimal response of the firm's management is to increase its effort provision in an attempt to avoid bankruptcy. Thus, bankruptcy threats would serve as a disciplining device and increased competition would reduce the firm's agency costs. Aghion, Dewatripont and Rey (1999) elaborate the relationship between financial structure, product market competition and internal incentives further. They demonstrate that while competition may have a detrimental effect on internal firm efficiency for low values of outside finance, competition enhances investment incentives and performance for high levels of outside finance.

With the focus on loan markets a number of recent contributions has analysed important aspects of the relationship between lending market structure and credit market performance. Broecker (1990) and Riordan (1993) have studied the consequences of adverse selection resulting from the unobserved characteristics of borrowers. They argue that increased competition may make adverse selection problems more severe when borrowers that have been rejected at one bank can apply for loans at other banks so that the pool of funded projects will exhibit lower average quality as the number of banks increases.<sup>1</sup> Shaffer (1998) has extended the analysis of winner's curse problems in lending and has also reported empirical evidence about the nature and magnitude of these effects. Contrary to the contributions mentioned above, by identifying the intensity of competition with the degree of product differentiation under asymmetric information Villas-Boas and Schmidt-Mohr (1999) have demonstrated how banks facing stronger competition may expose credit applicants to more precise screening. The central mechanism behind the result of Villas-Boas and Schmidt-Mohr relies on the argument that with stronger competition the banks have to compete more aggressively for the profitable projects.

In contrast to the models focusing on adverse selection, Koskela and Stenbacka (2000) use a model of mean-shifting investment technologies to study the relationship between market structure, risk taking and social welfare in lending markets. In their approach introduction of competition has been shown to reduce lending rates and to generate higher investments without increasing the equilibrium bankruptcy risk of borrowers. Thus, with investment volumes endogenized there need not be a tradeoff between market competition and financial fragility.

In a credit-rationing model that takes a Schumpeterian R&D perspective Petersen and Rajan (1995) have argued that credit market competition imposes constraints on the ability of borrowers and lenders to intertemporally share the surplus from investment projects so that lenders in a more competitive lending market may be forced to initially charge higher interest rates than lenders with more market power. Thus, as the market power of the bank increases,

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<sup>1</sup> Gehrig (1999) as well as Kannianen and Stenbacka (1998) extend this approach within the framework of models making it possible to explore the relationship between the incentives of banks for costly information

firms with lower credit quality obtain finance. In a different vein Dewatripont and Maskin (1995), who model the initial project choice as a problem of adverse selection and refinancing as one of moral hazard, have emphasized how credit market competition can offer a way not to refinance bad projects thus discouraging investors from undertaking them initially. Besanko and Thakor (1993) and von Thadden (1995)) have shown how banks with more market power might have stronger incentives to monitor the projects of borrowers and to establish long-term relationships. Subsequently, in the process of lending, the bank acquires information about borrowers' creditworthiness, which will constitute the basis for an informational monopoly relative to the bank's clients (see, also Dell'Ariccia (1998)). Insofar as creditworthy borrowers are unable to signal their quality to competing lenders, they are locked in a bank-client relationship and forced to pay borrowing rates above the competitive level.

Despite these contributions the relationship between credit market competition and the generated agency costs of debt is in need of further exploration. The present article offers the first systematic analysis making it possible to explicitly address how lending market competition, measured by the bargaining power of banks, affects the agency costs of debt finance. In such a setting, we show that more intense competition in lending markets will decrease the interest rates and lead to less risky investment projects with a lower rate of return conditional on success as long as the credit market does not face "too strong" adverse selection problems. Thus the agency costs generated by debt financing will decrease with more intense competition in lending markets. This is in sharp contrast with the finding by Petersen and Rajan (1995), who argue that more intense competition raises interest rates within an intertemporal framework of project funding.

We proceed as follows. The basic model of moral hazard describing the determination of investment projects for a given interest rate is presented in section 2. This section also delineates the first-best project selection as the benchmark for the evaluation of the impact of increasing degrees of lending market competition. Section 3 explores how the lending rate determination

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acquisition based on ex ante monitoring efforts and the market structure of the banking industry.

depends on the degree of competition. Here we formalize an analogy to the role played by bargaining power in wage negotiations in labor markets by modeling the lending rate determination as a solution to a Nash bargaining problem between a lender and a borrower. Such an approach incorporates the lending market structures of perfect competition and monopoly as special cases, and, what is important, allows us also to consider the full spectrum of intermediate degrees of competition. In section 4 we elaborate the relationship between the agency cost generated by debt financing and bank competition. Finally there is a brief concluding section.

## 2. A basic model of moral hazard

Consider an entrepreneur facing an investment opportunity, which requires exactly one unit of debt money.<sup>2 3</sup> The investment yields a random return  $x$ . Assume for simplicity that the investment project has two possible outcomes as follows

$$(1) \quad x = \begin{cases} R & \text{with probability } p(R) \\ 0 & \text{with probability } 1 - p(R). \end{cases}$$

The probability of success,  $p(R)$ , is assumed to be a decreasing and convex function of the rate of return,  $R$ , so that  $p'(R) < 0$  and  $p''(R) > 0$ . (1) is a general representation of the investment opportunities available and it captures the natural feature that a higher rate of return can be achieved only by sacrificing in terms of the success probability. In order to achieve analytical tractability for our analysis, and thereby also to exhibit the underlying economic

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<sup>2</sup> Since the analysis is focused on the relationship between lending market competition and the agency costs of debt, we directly restrict our attention to debt as the only available financial instrument without attempting to make the financial structure of firms an endogenous feature of our model. We regard this justified in light of the fact that a large number of studies in financial economics has concentrated on that issue.

<sup>3</sup> Also, we abstract from issues related to equilibrium credit rationing and refer to Bester and Hellwig (1987) for an extensive treatment of credit rationing in the context of moral hazard.



intuition as transparently as possible, we will formally restrict our analysis to the following specification:

$$(2) \quad p(R) = e^{-I(R-1)} .$$

We can make the interpretation that the parameter  $I$  captures the hazard rate of the project with the property that  $p'(R) = -Ip(R) < 0$  and  $p''(R) = I^2 p(R) > 0$ .<sup>4</sup> This functional form of the probability of success can be viewed as a reflection of a tradeoff whereby a more complex project generates a higher return conditional on success, but that the probability of success diminishes with project complexity. It can also be seen to exhibit a moral hazard effect. For instance, the effort of the entrepreneur, which is not directly observable by the lender, may be a decreasing function of the interest rate (for an elaboration of this effect see e.g. Clemenz (1986), 65-66).

The investor is assumed to be risk-neutral and finances the project with a debt contract governed by the principle of limited liability. The investor makes the project selection,  $R$ , so as to maximize the expected profit

$$(3) \quad \mathbf{p} = p(R)[R - (1+r)] ,$$

where  $1+r$  describes the interest rate factor. When the lending institution has committed itself to the debt contract, the projectholder's first-order optimality condition can be expressed as

$$(4) \quad \mathbf{p}_R = p'(R)[R - (1+r)] + p(R) = 0 .$$

Under the assumptions made, the second order condition  $\mathbf{p}_{RR} < 0$  holds so that (4) implicitly defines the optimal project selection,  $R^*$ . The optimal project selection is structurally

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<sup>4</sup> In what follows the derivatives are noted by primes for functions with one argument and by subscripts for functions with many arguments. Hence, for example  $p'(R) = dp(R)/dR$ , while

determined by (i) a moral hazard factor (i.e. the size of  $p'$ , which incorporates the parameter  $I$ ) and (ii) the interest rate,  $r$ . It is easy to verify that  $R_r^* > 0$ , meaning that a higher interest rate leads to a higher rate of return being realized conditional on success. However, a higher interest rate implies the selection of riskier investment project<sup>5</sup> with lower probability of success. Using the specification (2) the optimal project selection can be explicitly written as

$$(5) \quad R^* = 1 + r + \frac{1}{I} .$$

This can be rewritten as  $R^* - (1 + r) = 1/I$  so that, if successful, the investor's optimal project selection is associated with a rate of return exhibiting a premium relative to the cost of debt finance and that premium decreases with the hazard rate  $I$ .

A slightly more complicated way of describing project selection would be to assume that a project with a risk characteristic  $q$  yields a random return stream of  $R(q)$  with probability  $p(q)$  and zero with probability  $1 - p(q)$ . Under such circumstances the project's expected return varies with the chosen risk-return characteristics. It would be reasonable to assume that  $R'(q) > 0$  so that the return in the case of success is higher as  $q$  increases, while the probability of success decreases, i.e.  $p'(q) < 0$ . Such a formulation, however, leads to similar results as those reported in the present analysis.<sup>6</sup>

The bank is assumed to be risk neutral and, for simplicity, we assume that the opportunity cost of granting loans is zero. Consequently, the expected profits of the bank can be written as

$$(6) \quad V = p(R) (1 + r) - 1 .$$

The determination of the lending rate,  $r$ , depends on the relative bargaining power of the bank vis-a-vis the investor. It turns out to be useful to study this question, as we will do in Section 3, by using the Nash bargaining approach. Such an approach also captures the polar cases of a

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$A_x(x, y) = \partial A(x, y) / \partial x$ , etc.

<sup>5</sup> See Stiglitz and Weiss (1981) for a seminal article about this effect.

<sup>6</sup> This kind of specification has been used in a different context by de Meza and Webb (1999).

lending market structure with perfect competition and monopoly. In the case of a lending monopoly, the bank sets the interest rate subject to the constraint determined by optimal project selection by the investor. Similarly, with perfect competition the interest rate is determined by the contestability condition with expected zero profits for the bank.

## 2.1. The socially efficient project selection: A benchmark

Before initiating the analysis of the implications of changes in the degree of lending market competition for the interest rate and project selection, including the rate of return under success as well as the implied riskiness, it is useful to characterize a simple benchmark of socially efficient project selection. Maximization of expected project surplus in a world where agency-based incentive problems could be eliminated constitutes a natural candidate for such a benchmark.

The socially efficient project selection (in a first-best sense) can be obtained as a solution to the following maximization problem

$$(7) \quad \text{Max}_R \quad W = p(R)R - 1,$$

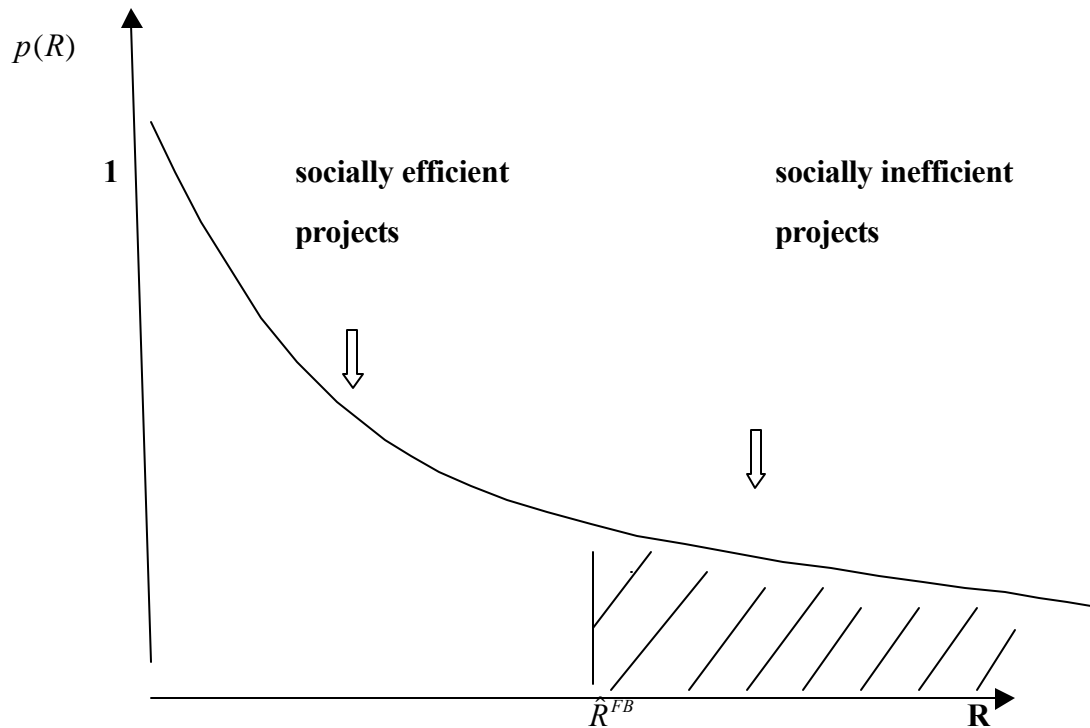
from which we can conclude that the resulting project selection,  $R = R^{FB}$ , has to satisfy

$R^{FB} = \frac{1}{I}$ . Such a socially efficient project selection will generate an expected project surplus  $W = W^{FB}$  given by

$$(8) \quad W^{FB} = \frac{p(R^{FB})}{I} - 1.$$

Equation (8) indicates that for the project to be socially efficient, i.e.  $W^{FB} > 0$ , the probability of success  $p$ , which depends on the choice of project, has to exceed the hazard rate  $I$  of the

project, which, in turn, describes how the probability of success diminishes with the project complexity. It is justified to implement a project from a social point of view if  $p(R^{FB}) > I$ . On the other hand, projects with  $p(R^{FB}) < I$  should not be implemented, since those projects generate a negative expected surplus. Nevertheless it may happen that the lending market will channel funds for the implementation of this kind of projects. Figure 1 describes the relationship between project selection,  $R$ , and the probability of success,  $p(R)$ . The social surplus is positive for  $R < \hat{R}$ , while it is negative for  $R > \hat{R}$ , where  $p(\hat{R}^{RF}) = \hat{I}^{FB}$ , i.e.  $\hat{R}^{FB} = 1 - \frac{1}{\hat{I}^{FB}} \ln \hat{I}^{FB}$ . If we had a distribution of projects differing according to their inherent technological properties as captured by the hazard rate,  $\hat{I}^{FB}$  determines the critical hazard rate above which it would be socially efficient to implement the project.



**Figure 1: The Probability of Success as a Function of Potential Project Return**

What is the relationship between the socially efficient project selection and the project the investor implements? Clearly, the nature of the project determines whether it creates value so as to justify its implementation. Equation (5) characterizes how optimal behavior on behalf of the projectholder will translate a particular debt contract (with interest rate  $r$ ) and a particular type of project (measured by the hazard rate  $I$ ) into a project selection. Comparing this with the investor's optimal selection of project reveals that  $R^* > R^{FR}$  and that  $p(R^*) < p(R^{FR})$ . Hence, under limited liability one ends up with excessive risk taking from a social point of view, because the investor does not care about the whole distribution, but only about the upper tail of the project return distribution.

What is the relationship between the socially efficient project and the nature of a debt-financed project that an investor would implement? Is it possible in our framework that the investor could implement a project which is socially inefficient in the sense defined above? One might argue that if the adverse selection problems associated with investment projects are not severe in the sense that the project has a sufficiently low hazard rate  $I$  and if credit is available at a sufficiently competitive interest rate, then the probability of success,  $p(R^*)$ , will exceed the hazard rate,  $I$ , and we would be on the left side of  $\hat{R}^{FB}$ . Along similar lines one might argue that if the adverse selection problems are severe or if credit is offered at a sufficiently high interest rate, the lending market will generate a project selection which is to the right of  $\hat{R}^{FB}$ . In such a case, the credit market imperfections would lead us to the implementation of projects, which are not justified from a social point of view. We will further analyze this question later on.

### **3. Lending rate determination as the outcome of Nash bargaining**

In the literature there is no unique and standardized way to characterize the intensity of lending rate competition. In traditional oligopoly models the consequences of increased competition are analyzed by increasing the number of competing lenders. Another approach, frequently applied in the area of industrial organization, is to measure the intensity of competition by the degree of

product differentiation like for example in the Hotelling type models of horizontal differentiation. A third way of capturing the degree of competition is to identify it with the lender's bargaining power relative to that of the borrower, i.e. to apply the Nash bargaining approach. This is the approach we will employ in the subsequent analysis. For our purposes this approach has two advantages: it both incorporates the monopoly bank and the perfectly competitive banking solutions as special cases and it avoids incorporation of market-specific, and often controversial, institutional details (like the precise type of competition) of loan markets as part of the analysis.

The lending rate is assumed to be determined as the outcome of a bargaining process between the bank and the projectholder subject to the constraint that the investor unilaterally determines the level of investment. Such a constraint reflects the feature that the bank has no instrument for enforcing any particular project selection in the presence of asymmetric information. In what follows we, further, assume that zero expected profit represents the threat point of both the projectholder and the bank. In such a situation the determination of the lending rate can be modeled as the solution to the following Nash bargaining problem

$$(9) \quad \text{Max}_r \quad \Omega = V^b p^{1-b} \quad \text{s.t.} \quad p_R = 0 \quad ,$$

in which  $b$  and  $1-b$  describe the relative bargaining power of the bank and the investor, respectively.<sup>7</sup> The first-order condition for this problem can be expressed as

$$(10) \quad \Omega_r = 0 \quad \Leftrightarrow \quad b \frac{V_r}{V} + (1-b) \frac{p_r}{p} = 0 \quad .$$

$V_r$  and  $p_r$  denote the partial derivatives with respect to the lending rate of the bank's and the investor's objective functions, respectively. Under the assumptions made, the second order

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<sup>7</sup> This approach to bargaining can be justified either axiomatically (see Nash (1950)) or strategically (see Binmore and Rubinstein and Wolinsky (1986)).

condition  $\Omega_{rr} < 0$  for the Nash bargaining holds, so that equation (10) implicitly defines the optimal lending rate as a function of the lender's relative bargaining power  $\mathbf{b}$  and other exogenous parameters.

As the investor chooses the level of investment in an optimal way, we can apply the envelope theorem to see that  $p_r = -p(R) < 0$ . As for the effect of the lending rate on the expected profit of the bank we have  $V_r = p(R^*) + (1+r)p'(R^*)R_r^* = p(R^*)[1 - (1+r)I]$ , where we have utilized the specification (2) as well as equation (5). Clearly, it holds that  $V_r > 0$  if  $\mathbf{b} < 1$ . Formally, this feature expresses that there is a conflict of interest between the bank and the projectholder with respect to negotiation regarding the interest rate. Substituting the derivatives mentioned above as well as the objective functions of the bank and the investor into the first-order condition (8) establishes that

$$(11) \quad \Omega_r = 0 \Leftrightarrow \mathbf{b}[1 - (1+r)I] = (1-\mathbf{b})\left[1+r - \frac{1}{p(R)}\right].$$

Equation (11) describes the determination of the lending rate  $r$  as a solution to a Nash bargaining problem. Solving (11) explicitly yields the interest rate,  $r = r^N$ , associated with the Nash bargaining problem

$$(12) \quad r^N = \frac{\mathbf{b}}{I} + \frac{1-\mathbf{b}}{p(R^N)} - 1,$$

where the  $R^N$  is determined by substituting  $r = r^N$  into (5) (see the equation (14) later on). From the Nash bargaining solution we get as special cases the interest rates in a lending market characterized by monopoly and perfect competition, respectively, as

$$(13) \quad r^M(\mathbf{b}=1) = \frac{1}{I} - 1 \quad \text{and} \quad r^C(\mathbf{b}=0) = \frac{1}{p(R^C)} - 1.$$

From equations (12) and (13) we can see that the impact on the lending rate of the bank's bargaining power depends on the relationship between the probability of success  $p(R^N)$  and the hazard rate  $I$ . Clearly,  $r^M > (<) r^C$  when  $p(R^C) > (<) I$ .

To characterize the relationship between the probability of success and the hazard rate and thereby the dependence of the lending rate on the degree of competition, we next systematically investigate how the project selection  $R^N$ , the probability of success  $p(R^N)$  and thereby the riskiness of investment project relate to the market structure in the banking industry. Substituting the lending rate  $r^N$  into equation (5) we can directly express the project selection in the Nash solution as a function of the bargaining power according to

$$(14) \quad R^N = \frac{1+b}{I} + \frac{1-b}{p(R^N)}.$$

For the cases of the monopoly bank and perfectly competitive bank we have

$$(15) \quad R^M(\mathbf{b}=1) = \frac{2}{I} \quad \text{and} \quad R^C(\mathbf{b}=0) = \frac{1}{I} + \frac{1}{p(R^C)},$$

respectively. By comparing the equations for  $R^M$  and  $R^C$  we see again that when a competitive lending market is monopolized, the effect on the optimal  $R$ , and on the probability of success, depends on the relationship between the probability of success  $p(R)$  and the hazard rate  $I$ .

One has to ask what is the critical project type, which determines the limit for the bank's participation as a financing institution? The participation constraint for the bank is defined by the



bank's expected profit being non-negative under Nash bargaining. This can be obtained by substituting  $R^N$  and  $r^N$  into the bank's objective function (6) so as to get

$$(16) \quad V^N \geq 0 \Leftrightarrow p(\hat{R}^N) \left( \frac{\mathbf{b}}{\hat{I}^N} \right) + (1 - \mathbf{b}) \geq 1 \Leftrightarrow \frac{p(\hat{R}^N)}{\hat{I}^N} \geq 1 .$$

According to (16) the participation constraint for the bank eliminates the implementation of such projects, for which the probability of success would be below the hazard rate. Therefore, in all cases where the bank has some degree of market power so that the expected profits are positive, the probability of success will necessarily exceed the hazard rate. On the other hand, the expected profits of the projectholder under the Nash equilibrium can be obtained by substituting  $R^N$  and  $r^N$  into the objective function (3) so as to yield  $\mathbf{p}^N = p(R^N) / I$ .

Formally, by differentiating the equations (12) and (14) with respect to the bank's relative bargaining power and using the specification (2) for the probability of success we find the following relationships to hold

$$(17) \quad R_b^N = A^{-1} \left( \frac{1}{I} - \frac{1}{p(R^N)} \right) > 0 \quad \text{as} \quad p(R^N) > I$$

and

$$(18) \quad r_b^N = A^{-1} \left( \frac{1}{I} - \frac{1}{p(R^N)} \right) > 0 \quad \text{as} \quad p(R^N) > I ,$$

where  $A = (1 - (1 - \mathbf{b})(I / p(R^N))) > 0$ .

The critical project type,  $\tilde{I}$ , is defined by the bank's participation constraint  $V^N = 0$ , and consequently, it must satisfy

$$(19) \quad V^N = p(R^N)[1+r] - 1 = 0 \quad \text{for } I = \tilde{I}.$$

How does this critical project type depend on the bank's relative bargaining power and thereby on the intensity of lending market competition? Differentiating equation (19) with respect to  $b$  and accounting for the fact that the probability of success depends on the bargaining power by affecting  $R^N$  both directly and indirectly via  $\tilde{I}$  gives

$$(20) \quad \tilde{I}_b = 0,$$

where we have made use of the feature that the critical project type  $\tilde{I}$  is defined by  $\tilde{I} = p(R^N(\tilde{I}))$ . The equation (20) indicates that the threshold in terms of project quality above which firms obtain loan finance does not depend on the bargaining power of the bank, because in the Nash bargaining game the bank's threat point is zero regardless of its market power relative to the investor.

We are now in a position to summarize our findings in

***Proposition 1: While the spectrum of project qualities obtaining loan finance is invariant to the bargaining power of the bank, intensified lending market competition will lead to lower lending rates and less risky projects.***

Proposition 1 appeals to intuition in light of the fact that the critical project type is determined by the bank's participation constraint, which is independent of the lending market structure as measured by the bank's bargaining power. This feature is in contrast to Petersen and Rajan (1995), who argue that bank's willingness to lend in the initial stage of a dynamic banking relationship increases with the concentration of the lending market as well as to the models emphasizing the adverse selection aspect of loan markets (see e.g. Broecker (1990), Riordan (1993) and Shaffer (1998) or Villas-Boas and Schmidt-Mohr (1999)), where the argument is

the reverse to that by Petersen and Rajan. Our model thus suggests that the intertemporal and adverse selection aspects represent crucial feature for generating a relationship between lending thresholds and lending market concentration.

#### 4. Agency cost of debt and lending market competition

In the previous section we have analyzed the determination of interest rates, project selection and thereby also project riskiness as a function of the bank's bargaining power. We now turn to study the relationship between for the agency cost of debt financing and lending market competition and for this purpose we identify lending market competition with the investor's bargaining power.<sup>8</sup>

Under Nash bargaining the indirect profit functions of the projectholder as well as the bank can be written as follows

$$(21) \quad \mathbf{p}^N = p(R^N)[R^N - (1+r^N)] = \frac{p(R^N)}{\mathbf{I}}$$

and

$$(22) \quad V^N = p(R^N)[1+r^N] - 1 = p(R^N)\left[\frac{\mathbf{b}}{\mathbf{I}} + \frac{1-\mathbf{b}}{p(R^N)}\right] - 1.$$

Hence, adding equations (21) and (22) yields the aggregate expected profits of the projectholder and the bank under Nash bargaining about the lending rate

$$(23) \quad W^N = \mathbf{p}^N + V^N = p(R^N)\left[\frac{1+\mathbf{b}}{\mathbf{I}} + \frac{1-\mathbf{b}}{p(R^N)}\right] - 1.$$

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<sup>8</sup> A somewhat related bargaining approach has been used in Haskel and Sanchis (1995) in order to evaluate the consequences of privatization for the firm's X-inefficiency. However, their analysis focuses on the intra-organizational agency costs rather than on the agency costs of debt financing.

The agency cost of debt financing associated with Nash bargaining,  $a^N(\mathbf{b})$ , can now be obtained as the difference between the expected project surplus generated by the socially optimal project selection and that generated through the process of Nash bargaining. Using equations (8) and (25) the agency cost of debt financing can be expressed as

$$(24) \quad a^N(\mathbf{b}) = W^{FB} - W^N = \frac{p(R^{FB})}{I} - p(R^N) \left[ \frac{1+\mathbf{b}}{I} + \frac{1-\mathbf{b}}{p(R^N)} \right].$$

In particular, for the cases of a monopoly bank and banking market operating under perfect competition the expressions for the agency costs of debt are

$$(25) \quad a^M = \frac{p(R^{FB})}{I} - p(R^M) \frac{2}{I} \quad \text{and} \quad a^C = \frac{p(R^{FB})}{I} - p(R^C) \left[ \frac{1}{I} + \frac{1}{p(R^C)} \right],$$

respectively.

Differentiating the agency cost of debt financing under Nash bargaining, i.e. equation (24), with respect to the bank's relative bargaining power parameter  $\mathbf{b}$  and accounting for the effect of  $\mathbf{b}$  on the rate of return, and thereby on the probability of success according to (2), yields

$$(26) \quad a_b^N = p(R^N)(1+\mathbf{b})R_b^N + \left( 1 - \frac{I}{p(R^N)} \right) > (<) 0 \Leftrightarrow p(R^N) > (<) I.$$

Thus, taking the participation constraint for the bank into account, the effect of lending market competition on the agency cost of debt finance can now be summarized in

**Proposition 2:** *Intensified lending market competition will decrease the agency cost of debt finance by leading to lower lending rates and less risky projects.*

Hence, our present analysis does not lend support to the commonly held view that there would be a trade-off between more intense lending market competition and higher agency costs of debt finance as has been argued for example, by Broecker (1990) and Riordan (1993). They have focused on how the phenomenon of adverse selection might present mechanisms demonstrating that more intense lending market competition may damage market performance. Although severe adverse selection problems leading to a sufficiently low probability of success might suggest that intensified lending competition could, in principle, increase the agency cost of debt finance, our analysis finds that such a possibility would be eliminated by the bank's participation constraint. As the bank does not find it worthwhile to finance such projects it follows that the lending market would break down in those cases. In the absence of sufficiently severe adverse selection problems Proposition 2 sends a strong and clear message. Intensified lending market competition will decrease the agency cost of debt finance by leading to lower lending rates and less risky projects.

## **5. Concluding Comments**

In this paper we have addressed the question of how lending market competition, measured by the bargaining power of banks, affects the agency costs of debt finance. It has been shown that intensified lending market competition will lead to lower lending rates and investment return distributions which are shifted towards lower, but less risky returns. Because intensified lending market competition induces such an effect on the distribution of investment returns it follows that increased lending market competition will reduce the agency cost of debt financing. Hence our analysis does not lend support to the commonly held view that there would be a trade-off between more intensive lending market competition and higher agency costs of debt finance.

While our model predicts that intensified lending market competition will reduce the agency cost of debt, the spectrum of project qualities obtaining loan finance is invariant to the bargaining

power of the bank. This feature is in contrast to Petersen and Rajan's (1995) intertemporal model as well as to the models emphasizing the adverse selection aspect of loan markets (see e.g. Broecker (1990), Riordan (1993) and Schaffer (1998)). In these models more intense lending competition either increases or decreases the threshold of obtaining loan finance depending on whether the intertemporal aspect or the adverse selection aspect dominates. Thus, our result suggests that the conclusions reached in the literature are sensitive to the presence of long-term lending relationships and adverse selection, which lie outside the scope of our model.

Our analysis has focused on a very simple and stylized model within the framework of which we have been able to explicitly address the relationship between the market power of banks and agency costs induced by debt contracts as financial instruments. As the analysis of Brander and Poitevin (1992) demonstrates there might be important interactions between agency costs at different hierarchical levels. One interesting direction for further research might be to investigate the interactions between the agency costs of debt identified in the present model with aspects of internal agency relationships within firms obtaining loans. Similarly, it might also be interesting to investigate how the agency costs of debt are related to strategic product market interaction between funded projects.

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