

Screening Process, Lending Standard And Information Incompleteness

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Abstract

This paper investigates banks' lending standards by endogenizing screening process in an incomplete credit market with hidden types. I propose a new setup of doubly-hidden types: types are not only hidden from banks but also unknown to firms until production takes place. Banks can use a costly screening process to achieve partly information accuracy, in other words, to balance the trade off between screening expenditure and information accuracy. I construct a simple optimal contract problem to find out the optimal screening expenditure, which depends on asset qualities and other aggregate economic conditions. Also, banks should not adopt costly screening under conditions such as high asset quality. It supports the empirical fact that banks lower credit standards for small and medium-sized enterprises during booms, which is a potential source of boom-bust cycles.

Keywords: Screening process, Lending standard, Information incompleteness

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