



Borrower–lender distance and loan default rates: Macro evidence from the Italian local markets



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ABSTRACT

I test the implications of borrower–lender physical and organizational distance for the loan default rate of Italian firms. I use a macro data set for the 1997–2011 period, which allows me to consider the effects of the international financial crisis too. I find that physical distance impedes information collection and monitoring and is inversely linked to credit quality. I also find that hard information can mitigate the adverse effects of physical distance on financing enterprises, showing the increasing importance of technological changes. Finally, I find evidence of the impact of organizational distance on default rates in less developed regions.

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‘The banker must not only know what the transaction is, which he is asked to finance and how it is likely to turn out but he must also know the customer, his business and even his private habits and get, by frequently <<talking things over with him>>, a clear picture of the situation.’

(Schumpeter, 1939, p. 116).

1. Introduction

The topic of borrower–lender distance has frequently been analyzed in banking theoretical models. Hotelling (1929) is the first to use this concept to explain price discrimination. More recently,

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technological changes and deregulation have raised the following question: does distance still matter in banking? Indeed, the reasons why it might not are numerous: on the one hand, the development of online and telephone banking, or alternative service delivery mechanisms (ATMs, etc.), tends to lower consumers' need for in-person interactions with their financial services supplier and, consequently, to reduce the transportation costs. On the other hand, the use of automated credit scoring systems throughout the entire life cycle of a bank loan (pre-screening, origination, and monitoring) has the potential to reduce the information costs associated with the granting of credit. Thus, the traditional argument on which the advantage of geographic proximity rests, namely lower transaction costs, is undoubtedly facing challenges.

In spite of the theoretical arguments, the empirical literature (for a review, see [Brevoort & Wolken, 2008](#)) offers answers to the aforementioned question that are all but clear-cut. In particular, empirical studies show no agreement on the combined effect of banking distance and the development of the credit scoring systems on banks' capabilities to screen and monitor borrowers. To the best of my knowledge, only three papers analyze this relation. The first one is by [Carling and Lundberg \(2005\)](#), who, using Swedish data, find no evidence of a relation between asymmetric information and borrower–lender distance, arguing that information technologies have made the need for proximity between banks and small firms obsolete. By contrast, [Agarwal and Hauswald \(2007\)](#) and [DeYoung, Glennon, and Nigro \(2008\)](#), using US data, find that the default probability increases with the distance between lender and borrower, but the effect is mitigated by the use of credit scoring systems.

The aim of this paper is to contribute to the limited literature on the impact of borrower–lender distance on credit quality. Using data on 103 Italian provinces over the period 1997–2011, I estimate the effect of two different measures of distance between banks and firms on the business loan default rate. The first measure expresses the physical distance between the borrower and the lender based on macro data. This indicator differs from that applied in some of the available empirical papers on this subject, namely a variable that measures the distance between two spatial points ([Degryse & Ongena, 2005](#); [DeYoung et al., 2008](#)), i.e. based on micro data. In my view, my distance indicator is able to mitigate problems, as illustrated by [Brevoort and Wolken \(2008\)](#), arising from spatial multiple locations both of banks and of firms. Based on the hypothesis that it is easier for a bank to acquire private information from borrowers who are physically nearer, I interpret this variable as a proxy for the intensity of use of soft information. To test the impact of technological changes, I consider a proxy for lending technologies that I also interpret as an indicator of the intensity of use of hard information. My second measure of distance expresses the organizational distance, i.e. an indicator that captures the distance between bank headquarters (top decision-making power) and borrowers ([Jiménez, Salas-Fumàs, & Saurina, 2009](#)).

To the best of my knowledge, this study is the first to analyze the impact of both physical and organizational distances between borrowers and lenders on loan defaults, expressly taking into account the effect of lending technologies, by using a macro data set. Moreover, through my analysis, I estimate the impact of soft and hard information on the loan default rates during a period of severe shocks, as in the case of the 2007–2008 international financial crisis, which is of particular interest. Last but not least, using a macro data set, I avoid any sample selection bias that might arise from the credit screening process ([Agarwal & Hauswald, 2007](#)).

As in the studies by [Agarwal and Hauswald \(2007\)](#) and [DeYoung et al. \(2008\)](#), I find that physical distance interferes with the information gathering and monitoring processes. The empirical evidence that I provide highlights the importance of soft information in the screening process of firms carried out by banks. Moreover, I find that the use of hard information can help mitigate the adverse selection problems due to physical distance. I interpret this outcome as evidence that the choice of banking lending technology is directly connected with the physical borrower–lender distance. For borrowers close enough to be visited inexpensively, the relationship lending approach should be preferred, while for far-away borrowers the transactional lending approach should be favored. In line with the expectations of [Petersen and Rajan \(2002\)](#), technological changes have reduced the importance of banking distance. With respect to organizational distance, I find that organizational distance negatively affects the screening process only in less developed regions.

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