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Special issue on banking
Preface

This issue of the *Review of Finance* brings together six articles in the area of banking. Currently credit markets are under the spotlight of public attention in connection with the macroscopic failures of banks in the subprime lending crisis, which makes research in this area particularly topical. A recurrent theme in the papers collected in this issue is banking competition: how it affects the availability of credit and real outcomes, how it should be measured, and how it is shaped by both regulation and developments in information technology. In particular, the papers focus on the costs of connected-lending and possibly mitigating benefits of new entry, the internal organization of banks in relation to their market positioning, the impact of consolidation on the geographical reach of banks, the link between market power and credit availability, the costs and benefits of universal banking, and the interaction between lending behaviour and government policy. All these issues are of paramount importance to understand how the structure of the banking industry will evolve after the crisis.

The effects of new bank entry on the leverage and growth of firms is an area where firm-level evidence is still limited. Giannetti and Ongena provide such evidence by drawing on the massive entry by foreign banks in Eastern European economies, and show that such entry has stimulated the growth of local firms, especially young ones, and that foreign banks' competition forced domestic banks to reduce credit to politically connected firms. These findings are an important reminder of the benefits brought by banking integration, at a time when these benefits are threatened by the financial crisis and its repercussions on Western banks and Eastern European economies alike.

Banking competition also depends on the way banks structure their internal organization and informational processing activities, as well as on how remote their lending decision units are from their clients. Using very detailed data for Belgian banks, Degryse, Laeven, and Ongena show that a bank's geographical reach is smaller when it faces large rivals with a hierarchical organization, a superior communication technology and fewer layers to decide on lending. Alessandrini, Presbitero and Zazzaro highlight that the process of banking concentration tends to increase the distance between lending decision-making centres and banks' customers, and show that in Italy this has been associated with stiffer financing constraints on customers.

This outcome has not been compensated by the concomitant expansion of banking networks, which reduced the distance between bank branches and customers. Both of these papers were presented at the 2006 conference on "The Changing Geography of Banking", sponsored by the University of Ancona and the *Review of Finance*.

A long-standing debate in banking is whether competition expands credit by reducing banks' market power and rationing, or rather reduces credit by crippling lending relationships. The paper by Carbó-Valverde, Rodríguez-Fernández and Udell shows that the answer depends on whether market power is measured by a concentration index, as often done in banking, or through the Lerner index, commonly regarded as superior in the industrial organization literature. Using Spanish data, they find that when the Lerner index is used, greater market power is associated with reduced credit availability, while concentration measures yield the opposite result.

In the last two decades, the separation between commercial and investment banking in the United States has been relaxed, and this has allowed some commercial banks to enter the investment-banking business. Laux and Walz analyze how this institutional change has affected banking competition. They show that universal banking enhances commercial banks' ability to compete with investment banks, since it enables them to offer jointly underwriting services and lending: such cross-selling helps universal banks to attract investment banking business, in particular from highly leveraged borrowers, and ends up reducing rents in underwriting.

A vast literature argues that credit market competition is restrained by a number of frictions: informational asymmetries, incentive problems as well as large switching costs. These frictions enable banks to form and maintain credit relationships, which partly overcome adverse selection and incentive problems. We still know little, however, about how government policy can affect credit market outcomes in an economy with relationship banking. The paper by Carlin and Rob provides such an analysis. In their setting, the market can feature two possible regimes: one where low quality borrowers face no credit rationing but are charged high interest rates, and another where these borrowers face credit rationing but pay lower rates. They show that government policies affect which of these regimes prevails: for instance, a policy of low interest rates makes it more likely that banks will set a liberal policy and lend to all borrowers, charging high rates to low quality borrowers, rather than ration credit to them.

The financial crisis seriously challenges our understanding of the functioning of the financial sector, and especially of the credit market. We are confident that the contributions in this issue of the *Review of Finance* will inspire further research to pick up this challenge.

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Special Issue Editors