Competition and the Cost of Debt*

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Abstract

Using a large sample of loans to publicly traded US manufacturing firms, this paper provides evidence that an intensification of product market competition among firms significantly increases the cost of bank loans. The analysis reveals that the effect is strongest in industries with high illiquidity and specificity of assets. This finding suggests that the liquidation value of assets is an important channel through which competition affects the cost of debt. Moreover, the paper shows that loans to firms that operate in more competitive industries contain more covenants restricting the firms’ financing and dividend policies. Overall, the results suggest that banks explicitly take into account the competitive environment of firms when pricing and designing debt contracts.

Keywords: Product Market Competition, Financing Costs, Financial Contracts

JEL Classification: G32, G34

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