Who Borrows from Whom? Market Segmentation in Consumer Loans

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Abstract

This paper develops a model of credit market screening with heterogeneous lenders, borrower default risk, and regulatory interest rate caps. Two lenders compete by offering menus of loan contracts and differ in their ability to enforce repayment and in their marginal lending costs. Borrowers are heterogeneous in both their willingness to pay for credit and their probability of repayment, which jointly decline with borrower risk. In equilibrium, borrowers self-select across lenders according to type, generating endogenous market segmentation. We show that interest rate caps distort optimal contract menus, inducing bunching, flattening repayment schedules, and shifting the cutoff type that determines which borrowers are served by each lender. The model rationalizes two robust empirical regularities: (i) non-bank lenders concentrate at the regulatory ceiling, while banks offer strictly lower rates, and (ii) default rates are systematically higher among non-bank borrowers. We further characterize the welfare-maximizing cap, highlighting the regulator's trade-off between broader borrower coverage and sustaining lender participation. Our results underscore how enforcement heterogeneity interacts with borrower risk to shape the effectiveness and unintended consequences of interest rate regulation.

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