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Chapter 10: Bank competition and financial stability

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Category: Handbook Chapter

Published: 29 Sep 2017

Page Range: 185–204

Collection: Economics 2017

DOI: https://doi.org/10.4337/9781785363306.00018

Under the traditional "competition–fragility" view, more bank competition erodes market power, decreases profit margins, and results in reduced franchise value that encourages bank risk taking. Under the alternative "competition–stability" view, more market power in the loan market may result in higher bank risk, as the higher interest rates charged to loan customers make it harder to repay loans, and exacerbate moral hazard and adverse selection problems. The two strands of the literature need not necessarily yield opposing predictions regarding the effects of competition and market power on stability in banking. Even if market power in the loan market results in riskier loan portfolios, the overall risks of banks need not increase if banks protect their franchise values by increasing their equity capital or engaging in other risk-mitigating techniques. The authors test these theories by regressing measures of loan risk, bank risk, and bank equity capital on several measures of market power, as well as indicators of the business environment, using data for 8235 banks in 23 developed nations. The results suggest that – consistent with the traditional "competition–fragility" view – banks with a higher degree of market power also have less overall risk exposure. The data also provide some support for one element of the "competition–stability" view – that market power increases loan portfolio risk. The authors show that this risk may be offset in part by higher equity capital ratios.

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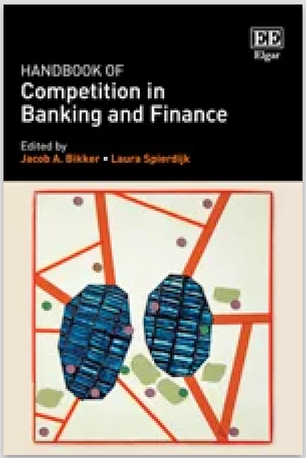

Handbook of Competition in Banking and Finance

Edited by Jacob A. Bikker and Laura Spierdijk

Handbook

Published: 29 Sep 2017

Print ISBN: 9781785363290

eISBN: 9781785363306

DOI: https://doi.org/10.4337/9781785363306

Pages: c 424

Collection: Economics 2017

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