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Bank competition, crisis and risk taking: Evidence from emerging markets in Asia☆

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ABSTRACT

This paper investigates the impact on financial stability of bank competition in emerging markets by taking into account crisis periods. Based on a broad set of commercial banks in Asia over the 1994–2009 period, the empirical results indicate that a higher degree of market power in the banking market is associated with higher capital ratios, higher income volatility and higher insolvency risk of banks. In general, although banks in less competitive markets hold more capital, the levels of capitalization are not high enough to offset the impact on default risk of higher risk taking. Nevertheless, during crisis periods, specifically the 1997 Asian crisis that has directly affected Asian banks, market power in banking has a stabilizing impact. A closer investigation however shows that such findings only hold for countries with a smaller size of the largest banks, suggesting that the impact of bank competition is conditional on the extent to which the banking industry may benefit from too-big-to-fail subsidies. Overall, this paper has policy implications for bank consolidation policies and the role of the lender of last resort.

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1. Introduction

Since the end of the 1980s, financial liberalization aiming to enhance financial sector competition has raised concerns for both researchers and policy makers. In countries with bank-based financial systems, financial liberalization is expected to create more efficient banking markets with lower cost of borrowing for entrepreneurs. Nevertheless, the externalities stemming from an increase in bank competition remain an open question and the occurrence of banking crises in both developing and developed countries over the last three decades has cast doubts on the role of competition in banking.

This paper aims to revisit and extend the nexus between bank competition and stability, particularly from the perspective of emerging economies with bank-based financial systems that have experienced financial crises. Indeed, a great number of studies have extensively examined the link between competition and risk in banking, but only few works have been dedicated to emerging economies. Furthermore, to our knowledge no study has investigated the impact of financial crises on the link between competition and stability in banking.

The occurrence of financial crises is an important dimension in the competition-stability nexus in banking because crises could directly modify market competitiveness as well as bank behavior in terms of risk taking. Financial crises have also spawned several banking reforms such as capitalizations and consolidations that might in turn alter the degree of competition and moral hazard in banking. Therefore, assessing the link between competition and the risk behavior of banks should take crises into account to control for various factors that might affect the link.

For such purposes, this paper focuses on the Asian banking industry for several reasons. First, Asian countries have undergone dramatic changes from expansionary financial liberalization in 1980s to a severe crisis in 1997 and again, have experienced rapid growth of financial globalization in the 21st century (Cook, 2009; Moshirian, 2008). Second, banking stability remains an important issue in both academic and policy circles in Asia, as banking is the predominant source of finance for private sector businesses in Asian countries (Adams, 2008). Yet, private sector businesses in Asia also remain vulnerable, where poor accounting standards, non-transparent management practices, and a governance system with weak protections for minority shareholders remain in the post-Asian crisis (Park, 2006). This corporate vulnerability can in turn deteriorate bank stability through risk-shifting mechanisms as highlighted by Stiglitz and Weiss (1981).

Moreover, the characteristics of competition, crises and reforms in Asian banking are particularly relevant for the purpose of our study. The unsupervised financial liberalization of the 1980s has resulted in stronger competition on the credit market, particularly in real estate markets (Sachs and Woo, 2000). This in turn was perceived as the origin of the 1997 Asian crisis. In response to the 1997 Asian crisis, financial reforms in the form of bank capitalizations and consolidations that might affect bank competition have also been widely implemented.[1]

With regards to bank consolidations, Asian countries have shown a remarkable trend. They have experienced a rapid growth of bank mergers and acquisitions (M&As) with a growth rate reaching 25% per year as of 2003 (Santoso, 2009). Such consolidations have led to the emergence of large banks and are likely to alter the degree of competition in banking, but whether these developments resulted in higher or lower bank stability remains unexplored, particularly during crisis periods.

In the meantime, bank consolidations could exacerbate “too-big-to-fail” effects, increasing risk-taking incentives through “gamble for resurrection” strategies to exploit state bailouts and to transfer losses from shareholders to the taxpayers. Some Asian countries experienced such kinds of bank moral hazard behavior during the 1997 Asian crisis (Cook, 2009). Although bank consolidations exacerbate the “too-big-to-fail” issues in banking, such policies were often followed during crisis periods to restore domestic banks’ financial strength.

Furthermore, foreign participation in bank consolidations in the post-1997 Asian crisis was also common in Asia. Williams and Nguyen (2005) point out that the time period following the 1997 Asian crisis was characterized by substantial changes in the Asian banking industry encompassing bank

[1] See Williams and Nguyen (2005) and Klingebiel et al. (2001) for further discussion on several financial reforms in Asian countries.