ELSEVIER

European Economic Review 44 (2000) 1–34

EUROPEAN ECONOMIC REVIEW

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Imperfect competition, risk taking, and regulation in banking

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Received 1 February 1997; accepted 1 April 1998

Abstract

We asses the welfare implications of banking competition under various deposit insurance regimes in a model of imperfect competition with social failure costs and where banks are subject to limited liability. We study the links between competition for deposits and risk taking incentives, and conclude that the welfare performance of the market and the appropriateness of alternative regulatory measures depend on the degree of rivalry and the deposit insurance regime. Specifically, when competition is intense and the social failure costs high, deposit rates are excessive both in a free market and with risk-based insurance. If insurance premiums are insensitive to risk then the same is true even if there is no social cost of failure. We find also that in an uninsured market with nonobservable portfolio risk or with flat-premium deposit insurance deposit regulation (rate regulation or deposit limits) and direct asset restrictions are complementary tools to improve welfare. In an uninsured market with observable portfolio risk or with risk-based insurance deposit regulation may be a sufficient instrument to improve welfare.

JEL classification: G21; G28

Keywords: Market power; Social cost of failure; Risk taking; Limited liability; Investor protection; Rate regulation; Asset restrictions

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0014-2921/00/$ - see front matter
PII: S0014-2921(98)00057-9

1. Introduction

We study the impact of banks' market power on risk taking incentives in the presence of limited liability and a social cost of failure. We find that the degree of rivalry of banks and the insurance regime are crucial determinants of the welfare performance of the market. Our model provides a framework to assess the effect of deposit regulation and asset restrictions in different insurance regimes.

Competition has traditionally been considered a source of excessive risk taking in banking and in consequence regulation has tried to control it. Rate regulation, entry restrictions, and charter limitations of banks (including the separation of commercial and investment banking) have been used by regulators to limit competition.[1] Deposit rate regulation was established in the US during the 1930s and in Europe at different times. In fact, rates have remained regulated in most countries until recently. Sometimes governments (specially in Europe) have even encouraged collusive agreements among banks (Baltensperger and Dermine, 1987; Vives, 1991). Other regulatory facilities like the lender of last resort and deposit insurance have been widely implemented in order to prevent runs and instability in the banking system. Regulatory measures provided a long period of stability of the banking system (from the 1940s to the 1970s).

The deregulation wave which followed from mutual fund competition for deposits in the US scrapped restrictions on rate setting. Indeed, by 1983 all depository institutions in the US could freely compete in rates offered to customers. In Europe rate setting is now mostly liberalized (with some exceptions like demand deposits in France).[2] Further, the need to better diversify the portfolios of banks has prompted a move towards less specialization in the sector. For example, savings institutions have been able to start acting like banks and compete directly with them.[3] In general, the regulatory changes have promoted competition by decreasing geographical and activity restrictions and thus reducing entry barriers.

The large increase in bank failures in the US in the 1980s (including the Savings and Loans' crisis) has prompted a debate over what has gone wrong in

[1] Basic regulation in the US is contained in the Pepper–McFadden Act (1927) and in the Banking Act (1933) (Glass–Steagall), the latter separating commercial from investment banking. In Europe universal banks (able to hold equity positions) were allowed in different countries following the German model. In some countries savings banks traditionally specialized in channeling savings into mortgage loans.

[2] See Gual and Neven (1992).

[3] However, recent regulation in the US (1991) requires S&L to hold at least 70% of assets in residential mortgages.