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# Banking market structure and financial stability: Evidence from the Texas real estate crisis in the 1980s ☆

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**Abstract**

This paper examines the relationship between banking market structure and financial stability. Using data on thrifts, a type of banking institution specializing in residential mortgage lending, I test two related hypotheses. First, competition reduces franchise value. Second, reduced franchise value induces risk taking. Testing the second hypothesis exploits predictions that when hit by an exogenous shock, the slope of risk with respect to franchise value becomes more negative because thrifts adopt "bang-bang" strategies and choose minimal or maximal risk. Using the Texas real estate collapse in the 1980s as a natural experiment, I find evidence supporting both hypotheses.

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## 1. Introduction

Casual observation suggests that recent financial crises, such as the thrift crisis in the United States and the financial crisis in Southeast Asia, were preceded by waves of financial liberalization that promoted competition. Hellmann et al. (2000) and Allen and Gale (2000) explicitly model how competition, as a result of financial liberalization, can induce banks to bid up deposit rates and reduce franchise value (the discounted stream of future profits). Declining franchise value, combined with a deposit insurance guarantee, accentuates risk-shifting incentives. The resulting moral hazard and risk taking, in turn, can lead to financial instability. Besanko and Thakor (1993) model the impact of competition on the asset side (i.e., the value of relationship banking) and reach a similar conclusion. However, no empirical evidence shows a direct link between banking market structure (i.e., competition) and financial instability.[1]

This paper empirically investigates the interactions among market structure, franchise value, and bank risk by examining a particular type of banking institution that specializes in residential mortgage lending, i.e., savings and loans or thrifts. Specifically, the paper tests two hypotheses. First, competition reduces franchise value. Second, declining franchise value, combined with government deposit insurance guarantees, leads to increased risk taking. Although no previous study has examined both hypotheses, several papers have studied the second one, contributing to an understanding of bank risk taking (e.g., Keeley, 1990; Saunders and Wilson, 1996; Gorton and Rosen, 1995). As discussed later, the results are mixed and suggest a number of methodological difficulties, such as measurement error and omitted variables, in testing for such a relation.

I use the Texas real estate collapse in the 1980s and its impact on the thrift industry as a natural experiment to test these hypotheses. Franchise value comes from two sources: rents on assets-in-place and future investment opportunities. Several authors (e.g., Marcus, 1984; Marshall and Venkataraman, 1999; Gan, 2003) show that when banks do not earn rents on assets-in-place, they adopt "bang-bang" strategies: banks with many positive net present value (NPV) investment opportunities adopt the safe strategies to get out of trouble, while those with few

[1] Studies using international data provide some indirect evidence. Demirgus-Kunt and Detragiache (1998) find that financial liberalization is associated with lower bank profits. However, in their study of bank regulations in different countries, Barth et al. (2000) do not find a strong link between concentration in a banking system and the likelihood of suffering a banking crisis. Following Keeley (1990), there are several studies on the relation between franchise value and risk taking. But as is shown in detail below, they have achieved only limited success.

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