Bank competition and financial stability: A comparison of commercial banks and mutual savings banks in Korea☆

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ARTICLE INFO

Article history:
Received 5 February 2013
Accepted 8 October 2013
Available online 17 October 2013

JEL classification:
G21
G23
L1

Keywords:
Bank competition
Stability
Risk shifting
Mutual saving banks
Commercial banks

ABSTRACT

In this study, we provide new evidence that the relationship between banking competition and financial stability varies depending on the characteristics of banks. By using a sample of two different types of banks, Korean commercial banks and mutual savings banks, we find that the non-linear relationship between competition and the stability of commercial banks reflects a trade-off between the interest effect and risk-shifting effect. However, consistent with Boyd and De Nicolo (2005), competition has a positive effect on the stability of mutual savings banks with greater business risk and weaker corporate governance. Our results provide important implications on banking competition policy.

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1. Introduction

Banking literature provides two alternative hypotheses regarding the relationship between bank competition and stability or risk-taking behavior. According to the conventional competition–fragility theory, higher competition in the financial services industry causes financial institutions to lose their market power, leading to a decrease in profitability. In order to recover from financial losses, financial institutions are more likely to invest in riskier portfolios. Consequently, this risk-taking behavior will undermine the stability of financial institutions (Keeley, 1990; Allen and Gale, 2000; Hellmann et al., 2000, etc.).

☆ We thank seminar participants at the Financial Stability Forum supported by the Bank of Korea for helpful Comments. Jin Q. Jeon is grateful to the Dongguk University Research Fund for financial support. Remaining errors are our own.

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Competition—stability theory, on the other hand, suggests that competition has a potentially positive effect on the stability of financial institutions. According to Boyd and De Nicolo (2005), banks with a greater market share in the loan market, which experience lower competition, tend to impose higher interest rates on their loans. Higher interest rates being charged by banks in a less competitive market may increase the risk-taking behavior of borrowing firms. Boyd and De Nicolo consequently argue that since the risk is ultimately shifted from borrowers to banks in this situation, the default probability of banks increases in the riskiness of bank loans.

A recent study by Martinez-Miera and Repullo (2010) provides partial support for Boyd and De Nicolo’s (2005) risk-shifting effect that the greater interest rates that exist in less competitive markets raise the risk of loans and thus make a bank bankruptcy more likely. They, however, additionally take into account the fact that greater interest rates also improve bank profitability, which is known as the interest effect, and suggest that there exists a U-shaped relationship between competition and the risk of bank failure. Thus far, empirical research has produced mixed results on the influence of bank competition on stability (e.g., Berger et al., 2009; Tabak et al., 2012a; Beck et al., 2013).

The purpose of this paper is to investigate the relationship between competition and stability by using a sample of two different types of banks: mutual savings banks (hereafter MSBs) and commercial banks in the Korean depository industry. Although previous studies have indicated the theoretical and empirical links between bank competition and stability, it has not as yet been investigated how this relationship varies across different types of banks. This paper attempts to fill this gap in the literature by examining whether there exist differences in terms of governance structure, loan characteristics and regulatory environments that cause banks to differently interact with industry competition.

The primary difference in the corporate governance structure between MSBs and commercial banks in the Korean markets is that MSB ownership is, in general, concentrated in the hands of a few individuals, who customarily belong to one family, while the ownership of commercial banks is widely dispersed.1 It is also important to note that since there are little mandatory requirements for disclosure, MSBs which provide little information on their financial situation are not affected by market discipline mechanisms. This creates a moral hazard problem in that the major shareholders and senior management are likely to take excessive risks in pursuit of private gains. Moreover, the borrowers of MSBs are mainly small and medium-sized enterprises (hereafter, SME), which possess greater business and credit risks than is true of the borrowers of commercial banks. Under this circumstance, MSBs in less competitive markets are more likely to be exposed to a greater degree of moral hazard and to charge higher interest rates on their loans.2 As a result, in light of the lower level of competition, MSB borrowers are more likely to choose risky projects to repay high interest rates, leading to the high possibility of defaults for both the borrowers and MSBs. As Martinez-Miera and Repullo observe, the risk-shifting effect may overwhelm the interest effect for MSBs.

This study investigates the hypothesis using the quarterly panel data of MSBs and commercial banks from 1999, the end of Asian financial crisis, through to 2011. We first estimate the level of bank competition. Although it is hard to directly measure competition, several possible approaches to this are presented in the banking literature. We follow Boone (2008a, 2008b) which measures competitiveness using operating efficiency, known as the Boone index. The conventional concentration ratio and the Herfindahl–Hirschman Index are also used as supplementary measures for bank competition. We employ the Z-score as a measure of bank stability which can capture how far a given bank is from insolvency. Finally, we estimate pooling regressions, panel regressions, and the difference-in-differences model to examine the relationship between the competitive levels and stability of MSBs and commercial banks.

Our empirical results generally support the hypothesis that the effect of bank competition on stability is different depending on the characteristics of the banks involved. The results of our multiple regressions show that competition has a significant and positive effect on the stability of MSBs with weak corporate governance. On the contrary, competition pressure significantly reduces the stability of commercial banks but this relationship is shown to be non-linear. Consistent with Tabak et al. (2012a), commercial banks are more stable at the very low or very high level of competition, while they are riskier at the medium level of

1 As of March 2011, the average ownership by the largest shareholders of large MSBs is 62.2%, whereas that of small and medium-sized MSBs is 70.4% (Korea Financial Supervisory Service, 2012).
2 It has been documented that the recent distress of MSBs has mainly been caused by excess risk-taking and, in some MSBs, unauthorized appropriation by major shareholders and senior management, and by the failure of effective monitoring on the part of internal and external governance mechanisms (See The Korean Herald, May 2, 2011; Korea Times, May 14, 2012).
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