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ACCEPTED MANUSCRIPT

Creditor rights and the market power-stability relationship in banking

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Abstract

I use the staggered passage of creditor rights reforms in 13 countries to examine how changes in creditor rights affect a) bank stability and b) the bank market power-stability relationship. a) There is statistically weak evidence that stronger creditor rights enhance bank stability; the result is not robust across specifications. b) Market power positively affects stability. However, there is asymmetry in the effect of market power on stability, depending on whether there is an increase or a decrease in creditor rights. The market power-stability relationship is stronger when a country weakens its creditor rights vis-á-vis when it strengthens its creditor rights.

Keywords: Bank risk-taking, *Lerner* index, Bank competition, Law and Finance
JEL codes: D42, G24

1. Introduction

I analyse the market power-stability relationship in the context of the legal setting in which the bank operates. I examine whether the effect of market power on bank risk-taking differs, depending on an increase versus a decrease in creditor rights. I find that the effect of market power on bank stability is significantly smaller when there is an increase in creditor rights, compared to the situation when there is a decrease in creditor rights. The policy implications are potentially large: in countries with poor creditor rights (such as the French civil law countries), policies reducing competition could be a fruitful channel for fostering stability in the banking sector. However, similar policies will be less effective in countries with stronger creditor rights (such as the English common law countries).

In this paper, I explore how bank-level stability is affected by changes in creditor rights and the interaction of creditor rights and bank market power. I

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