

Market structure, conduct and performance: Evidence from the Bangladesh banking industry

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Abstract

With regard to the market structure and performance in Bangladesh banking industry, there are two competing hypotheses—the traditional structure–conduct–performance (SCP) hypothesis and the efficiency hypothesis (EH). Using pooled and annual data for the period 1999–2002, this study tests the validity of these two hypotheses. In general, the results of this study support the EH hypothesis as an explanation for market performances in Bangladesh, but for definitive policy purposes, the impact of the banking structure needs to be explored further.

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1. Introduction

In bank performance literature, two competing hypotheses have been the subject of controversy for more than 40 years. The oldest hypothesis is the traditional structure–conduct–performance (SCP), also known as structure–performance (SP), hypothesis. According to SP hypothesis (Gilbert, 1984; Hannan, 1991), the profitability of a banking firm is dependent upon the market structure and the level of competition. The lower the level of competition in the market, the higher the economic rent for a firm. The basic message of the SP hypothesis is that a higher concentration ratio leads to a higher profitability. The hypothesis that concentration leads to higher profitability has been challenged by an alternative hypothesis, known as the efficiency hypothesis (EH). The EH emphasizes superior efficiency as an explanation for a firm's profitability. According to EH, "there is no relationship between concentration and profitability, but rather market share and bank profitability" (Smirlock, 1985, p. 69). In other words, the performance of an individual firm depends on the firm's degree of efficiency. In this hypothesis, the explanation for the relationship between the market structure and performance of a firm is dependent upon the firm's efficiency. If a firm enjoys a higher degree of efficiency than its competitors (that is, if the firm has a relatively low cost of production structure), the firm can maximize profits and increase its size and market share. This can be done by keeping the

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present market price level. Thus, the increase of profits and market share is the result of efficiency, not of a higher concentration ratio (collusion). The proponents of both hypotheses claim support in their favor.

There are three motivating factors that brought about this study. First, given the controversy between the two competing hypotheses, it is important to determine which hypothesis truly approximates and describes the Bangladesh banking industry. Determining the approximate behavioral relationship has important policy implications for Bangladesh because the presumed positive relationship between the market concentration and higher performance, for example, higher profits influences regulatory decisions regarding mergers and de novo entry. Increasing market concentration is also considered a social cost. Second, the relevance of the two hypotheses has been explored and tested in the context of the bank markets in developed countries. This study evaluates the validity of the two hypotheses in the context of the banking market in Bangladesh, a third-world country. Until 1980, the banking system of Bangladesh was quite concentrated and was regulated and protected from foreign competition. The domestic bank market was dominated by the operation of five nationalized commercial banks. This fact was conducive to collusive bank behavior leading to higher profitability. Thus, Bangladesh provides a good test case for evaluating the validity of the two competing hypotheses. Third, since the controversy of SCP and EH has not been resolved, the hypotheses deserve further exploration. This study can contribute to new findings in the banking performance literature.

This paper is structured as follows: Section 1 provides a brief description of the institutional structure of the Bangladesh banking market. Section 2 describes SCP and EH in the context of market structure and performance relationship. Section 3 provides data and methodology. Section 4 reports results and conclusions.

2. Institutional structure of the Bangladesh banking market

Bangladesh is a small country bordering India. The country seceded from Pakistan and gained independence in 1971. At that time, all commercial banks were nationalized by the government without compensation. The question of compensation did not arise at this time because the owners of the commercial banks were non-Bengalis who left Bangladesh before or during the war of liberation. The banking system of Bangladesh was highly regulated and protected from foreign competition and was concentrated until 1980. There were only five nationalized commercial banks that dominated the domestic banking market in Bangladesh at the time.

The first move towards competition in the banking market of Bangladesh was undertaken during the 1980s with the denationalization of the Pubali Bank, one of the five nationalized banks. At this time, the opening of private and foreign banks was allowed and encouraged. At present, there are 41 privately owned commercial banks operating in Bangladesh. Of those banks, 12 are foreign.

The structural features of the Bangladeshi banking system are provided in Table 1.

An explanation of Table 1 follows:

1. Until 2001, banking activity of commercial banks was dominated by nationalized commercial banks. There were four banks owned by the government of Bangladesh. The number of the nationalized commercial banks was four. Thus, only four commercial banks controlled over 48% of the total assets of the entire banking system in Bangladesh during the year 2000. Privately owned commercial banks controlled a little over 50% of the total assets until 2000.

Table 1
Bangladesh banking system total assets and distribution

Institutions	Assets in millions TK			Percentage share of assets		
	1999	2000	2001	1999	2000	2001
Commercial banks						
Nationalized commercial banks	446,350	506,119	589,366	48.99	48.02	27.92
Domestic private banks	376,197	450,481	1,405,466	80.96	82.24	92.41
Foreign banks	88,437	97,261	115,349	19.04	17.76	7.59
All private banks	464,634	547,742	1,520,815	51.01	51.98	72.03
Total banking system	910,984	1,053,861	2,110,181	100	100	100

Source: Publications from the Ministry of Finance of the government of Bangladesh. Percentage of assets is calculated by the author. The increase of asset growth was the result of many factors. One of the factors was the increase in exports supported by private commercial banks. Bangladesh's exports increased from \$249,860 (Million) in 2000 to \$269,150 (million) in 2001. *Source:* International Financial Statistics, published by IMF. The increase of exports increased bank deposits and assets.

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