Int. Fin. Markets, Inst. and Money 26 (2013) 100–112

Contents lists available at SciVerse ScienceDirect

Journal of International Financial Markets, Institutions & Money

journal homepage: www.elsevier.com/locate/intfin

Bank competition in the EU: How has it evolved?

Laurent Weill *

EM Strasbourg Business School, University of Strasbourg, France

ARTICLE INFO

Article history:
Received 13 July 2012
Accepted 8 May 2013
Available online 18 May 2013

JEL classification:
G21
F36
L16

Keywords:
Banking
Competition
European integration

ABSTRACT

Economic integration on the EU banking markets is expected to favor competition. However no study has been performed in the 2000s showing this trend. In this paper, we aim to fill this gap by measuring the evolution of bank competition in all EU countries during the 2000s with the Lerner index and the *H*-statistic. We do not observe a general improvement in bank competition in the EU. However, by applying β and σ convergence tests for panel data, we find that convergence in bank competition has taken place in EU countries.

1. Introduction

Economic integration in the European Union has aimed to favor competition in all industries. Increased competition was expected to provide gains for consumers through price reductions. In the banking industry, the awaited benefits are of particular interest for mainly two reasons. First, the expected gains are larger as in any other industry, as reductions in financial services prices mean notably lower loan rates which can lead to greater investment and thus favor growth. Second, banking literature has shown that these industries are characterized by the existence of switching costs and sunk costs (e.g. Yafeh and Yosha, 2001). These costs make harder the entry of new competitors on a banking market. Empirical banking literature thus mostly concludes to imperfect competition in studies done on developed and developing countries (e.g. De Bandt and Davis, 2000, for EU countries;

* Correspondence address: Institut d'Etudes Politiques, Université de Strasbourg, 47 avenue de la Forêt Noire, 67000 Strasbourg, France. Tel.: +33 3 68 85 81 38; fax: +33 3 68 85 86 15.
E-mail addresses: laurent.weill@unistra.fr, lweill73@hotmail.com

1042-4431/$ – see front matter
http://dx.doi.org/10.1016/j.intfin.2013.05.005

Fungacova et al., 2010, for Russia). Thus, benefits expected from increased competition are greater but harder to reach in the banking industry.

In EU banking industries, the process of integration has notably taken place through the deregulation of capital flows, the Second Banking Directive creating the single banking license, the removal of legal barriers to entry, and the creation of the single currency dropping the exchange risk for banks, all these steps favoring the cross-border acquisitions and in the supply of cross-border services.

However we can wonder if these efforts have contributed to increase bank competition in the EU. It is striking that there is a commonly accepted view that competition has increased in the EU banking industry in the last decade. For instance, Goddard et al. (2013, p. 2) pointed out that "there is a general view that competition in EU banking has increased over the last decade." Nonetheless, this view is not empirically supported.

A few studies have analyzed bank competition in the EU in the 1990s and the very beginning of the 2000s. They find evidence of a reduction in bank competition (Fernandez de Guevara et al., 2005; Weill, 2004), which is at odds with the commonly accepted view. However, this conclusion might not stand in the recent years. Indeed, while in the 1990s most mergers and acquisitions taking place in the EU banking industry were domestic and thus rather anticompetitive, this situation has changed in the 2000s with many major cross-border mergers and acquisitions which should enhance the degree of competition. The implementation of the Euro at the beginning of the 2000s is also expected to have an impact on bank competition in the EU through more supply of cross-border services and greater expectations of forthcoming entry of new competitors.

Our purpose in this paper is to fill the gap in the banking literature by providing evidence on the evolution of bank competition in the 2000s. Even if some barriers to entry remain and prevent perfect competition, we wonder if the recent changes have favored bank competition in the EU banking industries. We can also wonder how the financial crisis has exerted an impact on the competitive behavior of banks. To investigate these issues, we measure bank competition in the EU during the 2000s. In line with recent studies on bank competition (e.g. Claessens and Laeven, 2004; Berger et al., 2009; Turk-Ariss, 2010), we estimate non-structural measures: the Lerner index, and the H-statistic provided by the Rosse–Panzar model. These indicators have the major advantage to measure bank behavior directly rather than inferring the degree of competition from indirect proxies like market shares.

We also contribute to the banking literature by providing the first application to our knowledge of tests of convergence specified for panel data on non-structural measures of bank competition. We make use of two major concepts of convergence, β-convergence and σ-convergence. β-Convergence implies that countries with a lower level of bank competition have faster growth rates than countries with a higher level of bank competition. σ-Convergence is observed if each country's level of bank competition is converging to the average level of the group of countries. As competition in banking might be hampered by specific obstacles, one can wonder if we have observed convergence in bank competition across EU countries. Namely, even if there is no general trend of enhanced competition in all EU countries, banking integration can take place through convergence toward the same level of bank competition. Indeed, integration should lead to the law of one price. But the persistence of obstacles to greater bank competition can prevent the application of this law in banking. Nonetheless EU banking industries can have converged toward the same level of imperfect competition.

The structure of the paper is as follows. Section 2 describes the methods used for the measures of competition and the convergence tests. Section 3 develops the empirical results. We provide some concluding remarks in Section 4.

2. Methodology

Empirical research on the measurement of bank competition provides several tools. These can be divided into the traditional Industrial Organization (IO) and newer empirical IO approaches. The traditional IO approach proposes tests of market structure to assess bank competition based on the Structure Conduct Performance (SCP) model. The SCP hypothesis argues that greater concentration causes less competitive bank conduct and leads to greater profitability of the bank. In this model,