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# Financial opening, deposit insurance, and risk in a model of banking competition

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**Abstract**

We study the impact of competition on banks' risk-taking behavior under different assumptions about deposit insurance and the dissemination of financial information. While opening increases banks' riskiness, a risk-based deposit insurance or, alternatively, the public disclosure of financial information, are likely to mitigate this effect. Moreover, the limiting cases of uninsured but fully informed depositors, and risk-based full deposit insurance, yield the same equilibrium risk level. Although the welfare consequences of increased competition depend on its impact on risk, financial opening unambiguously improves welfare as we approach the limiting cases. © 2002 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

Whereas in the past regulators aimed at limiting "disruptive competition" as a way of promoting sound banking practices, the current regulatory credo tends to stress that competition, by improving efficiency and reducing costs, may limit the vulnerability of the banking sector to adverse shocks. This change of attitude is behind regulatory changes such as the elimination of rate

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controls, the despecialization of banks, and the opening of domestic financial markets, recently implemented in several countries as a way of fostering bank competition.[1]

In the aftermath of the financial crises in Southeast Asia, the issue of competition and solvency is again in the forefront. While many experts claim that bad lending practices in crisis countries were in part caused by the burden that increased foreign competition, in the form of "excessive" foreign lending, imposed on domestic banks, others blame protectionist policies in the past for the fragility of the domestic financial sector at the time of the financial opening.

A final assessment of the impact of competition on bank soundness remains elusive: Several factors interact in the determination of risk-taking behavior in the banking industry. In particular, governments that guarantee bank deposits may limit the incentives of depositors and, in turn, of banks, to monitor lending practices, restricting the scope for market discipline and reducing the beneficial effect of competition on banks' asset quality.[2] However, monitoring by market participants is conceivable only when information on banks' assets is fully disclosed, and freely available. Since this is rarely the case, one could argue that a deposit insurance agency may be in a privileged position to evaluate the quality of banks' portfolios and to exert a disciplining effect by charging banks a risk-based contribution to the insurance fund.[3]

In this paper, we assess the impact of increased competition on banks' risk-taking behavior under different assumptions regarding deposit insurance and information disclosure. Using a spatial competition framework à la Salop (1979), we model increased foreign and domestic competition as a fall in entry and transportation costs, respectively.[4] Our banks are fully financed by deposits, and select their investments from a pool of projects.[5] We introduce a moral hazard problem by allowing banks to choose the monitoring intensity,

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[1] See, for instance, Ali and Greenbaum (1977) and Dewatripoint and Tirole (1994).

[2] The relationship between deposit insurance and bank failures is discussed in Mishkin (1992), Keeley (1990) and O'Driscoll (1988). Our discussion abstracts from bank runs due to informational problems as a rationale for the existence of deposit insurance (see Diamond and Dybvig, 1983).

[3] As noted in Cordella and Yeyati (1997), even when information is disclosed, market discipline would be effective inasmuch as risk is under the control of the bank.

[4] Spatial competition models provide a simple and rich framework in which banks face an imperfectly elastic demand for financial services. See, e.g., Matutes and Vives (1996, 2000) for models of banking competition à la Hotelling, and Besanko and Thakor (1992), Chiappori et al. (1995), and Economides et al. (1995) for applications of the circular version used in this paper.

[5] In this paper, we abstract from competition for loans. For a rigorous discussion of the problems arising from "double-sided" Bertrand competition in banking, see Yanelle (1989, 1997), and Gottardi and Yanelle (1997). See also Caminal and Matutes (2002) for a model that deals with monitoring incentives and risk as a function of loan competition.

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