# Comments on “Market power and stability of banks in CEE”

Evan Kraft
American University and Croatian National Bank
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# Ambitious empirical work

- Using Bankscope data on banks in 15 CEE/SEE countries from 1997-2012, poses questions about
  - Franchise value
  - The competition-stability nexus
  - The competition-pricing nexus
  - The “quiet life” hypothesis (competition-bank efficiency nexus)

# Complexities of the competition-stability relationship in banking

- Older literature has tended to presume that decreased competition increases stability in the banking system because
  - Greater market power leads to greater profitability, increasing buffers against losses
  - Banks with higher franchise value have strong incentives to maintain that franchise by avoiding bankruptcy, therefore taking less risk

# Newer twists: competition may increase stability

- Several more recent papers have argued that, in addition to benefiting the whole economy through provision of better and cheaper banking services, greater competition
  - Lowers chances of banks becoming too big to fail, thereby lowering social costs
  - By decreasing TBTF probability, increase x efficiency.

# Risk-taking, competition and capitalization

- Arguably unclear relationship
  - Well-capitalized banks have more skin in the game so they should avoid risky clients
  - But, to achieve a given ROAE, banks would need more profits from their assets with a higher capital/asset ratio, so they might take more risk

# A broader and subtler understanding of the uses of market power

- Market power can be used to raise profits and prices in the short-run. This use of market power will show up in a Lerner Index.
- Market power may also be used to choose the best clients, achieving lower portfolio risk but lowering the probability of bankruptcy. This kind of market power should be closely correlated with increased franchise value.
- Broad point: banks do not supply a homogeneous product and choose a price, they can vary the quality of the product (riskiness) as well as the price
- And the possibility of risk-shifting provides extra dimensions to the usual output-price choice

# A closer look at the findings: Franchise Value

- Franchise value depends positively on both definitions of market power. (OK)
- Franchise value depends negatively on efficiency when using the Lerner index (not clear)
- Franchise value depends positively on market share—or is this really bank size? Could it be proxy for TBTF or TBTS?
- Franchise value depends negatively on a capital ratio—not clear what is going on here
- Note that regulation variable is very narrowly formulated (reserves held at central bank)—could try to use World Bank data on quality and scope of supervision and regulation
- Might also look at a specification with lagged FV

# A closer look at findings: stability

- For Z-score and leverage stability, Lerner index is positive in crisis. This makes good sense. Less clear why CE is insignificant
- For portfolio stability, both market power indices are positive and significant in crisis. This is quite a strong finding, suggesting a clear advantage for limited competition. Market share (size) also significant for portfolio stability, reinforcing the TBTF or TBTS story.

# Alternative stability index

- Note that these are ex-post indicators of risk.
- Must be careful in interpreting this as indicating ex-ante risk taking.
- Broad story seems to support previous findings.

# Non-linearities in stability?

- It seems quite possible that there is a threshold beyond which more competition leads to significantly greater probability of instability
- Or a logarithmic or exponential function
- Further experiments with specification might be useful here

# Prices and costs

- A little unclear why results are uneven here
  - Lerner significant for NIM and implicit lending costs
  - CE significant for implicit lending and implicit deposit costs

# Support for the quiet life hypothesis

- If the quiet life is not achieved by raising interest rates but by taking less risky clients, then the insignificance of the price-oriented Lerner index, and the significance of the CE index, make sense

# Some thoughts on policy implications

- Be cautious! Its complicated
- Evidence so far supports not going too far in limiting market power
- But quiet life findings and strong evidence of TBTF and TBTS effects make me unwilling to endorse policies that allow banks to get as big and as complex as they want
- Note that models do not directly deal with risk-shifting issues, so no clear implications
- Generally, stricter regulations will tend to impede competition, which these exercises tend to support.