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Bank Concentration and Crises

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Diametrically opposed views exist on the question of whether bank consolidation in various countries enhances financial stability. Some analysts emphasize that large banks can diversify better, earn higher profits, take fewer risks, and can be monitored by regulatory agencies more easily, all of which bodes well for stability. However, other studies maintain that because large banks frequently receive subsidies under "too big to fail policies," these financial institutions in fact may take greater risks, and indeed their very size and complexity may make them more difficult to oversee.

In an effort to resolve these opposing interpretations, co-authors **Thorsten Beck**, **Asli Demirguc-Kunt**, and **Ross Levine** study the impact of bank concentration, bank regulations, and national institutions on the probability of experiencing a systemic banking crisis. In **Bank Concentration and Crises** (NBER Working Paper No. 9921) they rely on data gathered from 70 countries over the period 1980-97. It is the first paper to examine the impact of concentration on crises across a broad cross-section of nations while controlling for differences in regulatory policies, national institutions governing property rights and economic freedom, the ownership structure of banks, and macroeconomic and financial conditions.

The researchers define banking concentration as the share of assets of a country's three largest banks. In their analysis, they control for international differences in deposit insurance practices, capital regulations, restrictions on bank activities and ownership, and the overall economic environment. All of these factors are evaluated in regard to episodes of banking sector distress occurring during the years studied. The researchers acknowledge that systemic banking crises are not always easy to define or to date. Episodes of banking sector distress are classified as systemic crises if emergency measures had to be taken to assist a nation's banking system (bank holidays, deposit freezes, blanket guarantees to depositors or creditors, or large-scale nationalization.)

A financial crisis also was considered systemic if non-performing assets reached at least 10 percent of total assets at the height of the crisis, or if the cost of rescue operations was at least 2 percent of GDP. The authors note, too, that many crises continue for years. They exclude the years after the initial year of the crisis because during a crisis the behavior of some of the explanatory variables is likely to be affected by the crisis itself, leading to reverse causality. Yet including the entirety of the crisis years does not change their conclusions. Also, some countries experience multiple crises. (Turkey, for example, suffered systemic banking crises in 1982, 1991, and 1994.)

Beck, Demirguc-Kunt, and Levine produce three major findings. First, they find that crises are less likely in more concentrated banking systems, even after controlling for a wide array of macroeconomic, regulatory, and institutional factors. This is consistent with the concentration-stability argument that banking systems characterized by a few large banks are more stable than less concentrated banking markets. The researchers do note that there is some evidence that the stabilizing effect of bank concentration is weaker at higher levels of concentration, but they maintain that this does not change the fact that the overall impact of concentration on fragility is negative and that the relationship holds when controlling for bank regulations and the overall competitive/ institutional climate.

Second, more competition lowers the probability that a country will suffer a systemic banking crisis. The data indicate that fewer regulatory restrictions on banks - lower barriers to bank entry and fewer restrictions on banking activities - reduce bank vulnerability. Indeed, entry barriers and activity restrictions have a destabilizing effect on banking systems. The evidence shows that banking systems where a larger fraction of entry applications are denied, and those where regulations restrict banks from engaging in non-lending activities, have a greater chance of experiencing a systemic crisis. The authors caution, however, that they do not have time-series data on the regulatory variables, thus lowering the power of the regulatory results. Nevertheless, the data never support the view that more competition induces greater fragility. To the contrary, more competitive banking systems and those with fewer entry regulations and activity restrictions tend to be more stable.

Third, countries whose national institutions promote competition in general have a lower likelihood of suffering a systemic banking crisis. The composite indicator of institutional development always has a negative and significant sign in the crisis regressions. Moreover, Beck, Demirguc-Kunt, and Levine find it difficult to single out the independent effect of bank regulations and bank policies that promote competition from the overall institutional environment. Yet countries with what are generally considered more desirable traditions (property rights, rule of law, political openness, low corruption) also tend to be countries with bank regulations and bank policies that support openness and competition. Thus, while bank regulations and policies that support competition also support bank stability, these regulations and policies cannot be viewed in isolation from the overall institutional environment.

In terms of linking these findings to specific parts of the concentration-stability view, the finding that competition reduces fragility is inconsistent with the argument that concentrated banking systems boost profits and therefore reduce fragility. Rather, the evidence is more consistent with the view that concentrated banking systems tend to have banks that are better diversified or are easier to monitor than banks in less concentrated banking systems.

-- Matt Nesvisky

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