# BANK COMPETITION

*Seyhan Pencapligil**

ABSTRACT

Although competition in general is good, as it increases efficiency, there is a trade-off between competition and financial market stability when it comes to banking. This is due to the unique features of banking such as increasing returns to scale, asymmetric information, systemic risks, liquidity, high leverage, and complexity. Therefore, too much competition may create more problems than it solves. In banking systems that are characterised by intense competition, the supervisors have to be very diligent to prevent large-scale problems and losses.

Competition is good, as it increases efficiency, lowers prices, and enhances choice and innovation. For many sectors, more competition is better and one cannot have too much competition. This is because competition is a dynamic process which ensures that inefficient players are driven out of the market and that the remaining number of players is at the equilibrium for there to be efficiency and required levels of return on the investment. For instance, if there are too many car manufacturers in a country, ignoring the export possibilities for the sake of the argument, they will necessarily go into a price/product war, which will leave the most efficient few surviving and securing reasonable returns on their investment. Corollary to this

is that if the returns in a sector are excessive given the investment required and risks undertaken, then the chances are that there is not enough competition (e.g. there may be barriers to entry, asymmetric information etc).

While the foregoing holds in general, it is not that clear-cut that competition among banks should follow the broad argument that competition in industries is efficiency/welfare enhancing. Conventional wisdom about competition suggests that competition eliminates restrictive practices and reduces margins between deposit and lending rates, thereby improving the performance of the banking industry.

This standard competition paradigm argues that competition ensures that costs are minimised and the prices of banking services are such that resources are allocated efficiently. In other words, competition promotes efficiency and shares the benefit of the financial system with the rest of the economy. Some other theoretical work says that greater competition between banks narrows the gap between interest rates facing lenders and borrowers and should therefore make for faster long-run growth (e.g. Sinclair, 2000).

However, banking industry has several unique features, making it hard to evaluate the consequences of increased banking competition. As noted by Ward (2003), "an analysis of competition between banks must recognise the special properties of banks. In banking, markets fail in every conceivable way: the market is characterised by increasing returns to scale (so it pays to be bigger); banks and their customers have highly imperfect information about each other; and bank failures can cause catastrophe and so the whole system is implicitly underwritten by the state." To these, one can add that banks are highly leveraged and liquid in comparison with other companies and usually more complex.

Regarding the increasing returns to scale, banks usually have to reach a critical mass to become profitable. That is why it may be more efficient from a macroeconomic point of view if there is some level of market concentration. To make an analogy with a different sector, telecom firms have invested hugely in competing fibre optic cable

networks, and this has led to overcapacity, extremely low prices, and the threat of widespread bankruptcies. Similarly, the recent wave of bank mergers, closures, and consolidation is a testimony that bank branches within 20m distances to one another may have been very competitive, but they were inefficient.

For the problem of asymmetric information, one needs to look at the lending and deposit functions separately. On the lending side, it is shown that the average quality of a bank's pool of borrowers declines as the number of competitors in the market increases, leading to financing of economically unfeasible projects. (Shaffer, 1998) Broecker (1990) and Riordon (1993) also argue that increased competition may create adverse selection problems. In an economy where there are too many banks, all striving for market share, a low-credit quality loan applicant is more likely to receive credit than in an economy with some level of bank market concentration. On the deposit side, it is usually taken for granted that depositors cannot fully discriminate between safe and unsafe banks. Therefore, in many countries, some form of a safety net (deposit insurance) has been put in place to protect, at least partially, the interests of the depositors. Nevertheless, as noted by Broaddus (2004), 'given the presence of the financial safety net, competitive pressures also may induce banks to act in ways that distort markets, degrade the safety and soundness of the banking system, and put taxpayers at risk.' A recent example is the failure of some 20 banks in Turkey and the concurrent economic crisis that cost the taxpayers some US$50 billion only for the bail-out of the troubled banks. Turkish banks then enjoyed, and abused, 100 per cent state guarantee on all deposits. Another unique feature of the banking industry is that problems tend to be contagious and that individual bank failures affect the rest of the system negatively. This is yet another reason why governments intervene, often at the expense of the taxpayer, unlike many other industries, where the ailing is normally let fail.

Banks are highly leveraged companies and the finance theory holds that that the shareholders of leveraged corporations are more likely to take risks, as such behaviour would increase the value of their equity (if the equity is viewed as a call option on the total assets of the company). This is why, if left to their own devices, shareholders

will be financing risky projects at high rates and secure huge returns on their equity if such projects succeed, or lose mainly depositors' money if not. This is also why there are strict regulations on lending, capital adequacy, large exposures etc, again unlike other industries.

Finally, banks are quite liquid and complex corporations and a troubled bank may continue functioning for prolonged periods and become a bigger threat to the system in the progress. Paying the salaries of the staff or other expenses, as well as meeting the demands of occasional account-closers hardly represents a problem for even a negative-equity bank, thanks to the liquidity nature of the business. Furthermore, given the complexity of a bank's operations, losses may be hidden from the inadequate supervisors for long periods. In other words, in a too competitive environment, it might take some precious time for an inefficient, loss-making bank to become insolvent, especially if the supervision is imperfect. Usually, during this time slot, the troubled bank will try all means to extend survival, including financing risky and unfeasible projects, offering off-the-market deposit rates, channelling funds to the shareholders and the like; and the economic costs of such will usually be borne by the taxpayer or the other banks in the system.

It is not surprising, therefore, that in recent years, many governments have had banking crises soon after they have liberalised and promoted competition. Furthermore, liberalisation increases fragility more in countries with weaker institutions (Demirguc-Kunt and Detragiache, 1998).

With the recent licensing of new banks and the privatisation of Savings Bank, now 17 banks in Albania are trying to get a decent market share of a total of US$3.5 billion deposits and some US$0.5 billion loans. If we also consider that Savings Bank, now Raiffeisen, holds more than half of the deposit market, it will become clearer that there is tough competition among the other 16 banks. This is also evident that the aggregate return on equity for these banks, almost all owned by foreign capital, has been far from attractive for a foreign investor given the risks associated. It is also true that banking sector in Albania enjoys a far broader variety of services and a higher level of technology than any other sector in the country. Finally, the

spread between one-year deposit and lending rates now stands at somewhere between 5 to 6 percentage points, which compares very well with most of the countries in the region. All these are signs that there is a high level of competition in the banking; whether there is too much competition, time will show. But, the obvious implication is that the Bank of Albania, the sole supervisor of the system, must be far more diligent now than at any time in the past.

REFERENCES


- *Broaddus, J. A., 2004, "Competition in Banking: Achieving the Right Balance," Bank Structure Conference by the Federal Reserve Bank of Chicago.*
- *Broecker, T., 1990, "Creditworthiness Tests and Interbank Competition," Econometrica, 58, pp. 429-452.*
- *Demirguc-Kunt, A. and E. Detragiache, 1998, "Financial Liberalisation and Financial Fragility," IMF Working Paper, 1998/83, June.*
- *Riordan, M., 1993, Competition and bank performance: a theoretical perspective, Cambridge University Press.*
- *Sinclair, P. J. N., 2000, "Central Banks and Financial Stability," Bank of England Quarterly Bulletin, pp. 384-389.*
- *Ward, J., 2003, "What is so Great About Competition in Banking?", available on www.cerf.com.ac.uk*


* Seyhan Pencapligil: General Director, National Commercial Bank.