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FINANCIAL STABILITY, COMPETITION AND EFFICIENCY IN LATIN AMERICAN AND CARIBBEAN BANKING

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Using a sample of 272 commercial banks from fifteen Latin American countries for the period 2001-2008, we estimate cost and revenue efficiency scores, financial stability scores (*Z*-scores) and competition scores (Lerner indexes and Boone indicators) at the bank level. The Granger causality technique in dynamic panels is used to establish dynamic relationships among these variables. We find evidence that strongly supports the “quite life” hypothesis, while we also find partial support for causality running in the opposite direction. Moreover, the results suggest that more competition is conducive to greater financial stability (when the revenue efficiency score is used). Banks seem to achieve market power through better efficiency, leverage and earning ability. As size and complexity increase, however, agency problems and increasing risk-taking might start gaining momentum, generating inefficiency and fragility.

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I. Introduction

The global financial crisis of 2007 has not only shaken most of financial markets and institutions, but also key underlying assumptions regarding financial market mechanisms. During the run-up to the crisis, it became apparent that bubbles could survive for long periods of time despite the presence of well-informed and well-financed rational arbitrageurs. Moreover, the "efficient markets hypothesis" would rule out such a phenomenon (Abreu and Brunnermeier 2003; Brunnermeier et al. 2009). For a long time, competition was not thought to be an important determinant of financial stability. In fact, in most countries standard competition policy was not applied fully to financial markets. Although competition policy had been substantially strengthened at the national level over the last couple of decades, regulators in most countries were complacent about market power in national markets. The crisis also changed that. Particularly, the largest and more interconnected financial institutions in developed markets have failed.

The Latin American and Caribbean banking systems have shown an apparent resilience during the current crisis. The region's financial systems have undergone intense structural change since the 1990s. In addition, starting in the nineties, consolidation and restructuring have changed the competitive environment (Levy-Yeyati and Micco 2007; Yildirim and Philippatos 2006; Carvallo and Kasman 2005; BIS 2007). However, there are concerns regarding the impact of increased concentration on the level of competition, performance and the financial stability of the banking systems in the region.

As the experience of the crisis underscores, a better understanding of links between stability and competition is a must. Moreover, the studies so far have focused on structural and aggregated measures of competition, concentration, stability and efficiency, mostly in a static setting. In the related literature, studies have paid attention to performance (cost or profit efficiencies) or competition (and/or risk) of banks. In this paper, we integrate these dimensions in search of mutual dynamic relationships between bank efficiency, competition and financial stability in the banking sectors within the region. The sweeping changes in the global regulatory paradigm will affect the way the region regulates its financial markets. Competition policy will be part of those changes and solid empirical evidence to guide it is required.

This paper extends the related literature in several ways. First, we estimate market power at the bank level by computing Lerner indexes for an unbalanced