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Competition and Bank Stability

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Abstract

Does an increase in competition increase or decrease bank stability? I use a novel way to capture changes in banking competition by exploring how the exogenous state-specific process of banking deregulation gradually lowered entry barriers into urban banking markets. I find that the increase in market contestability significantly improves bank stability. This result is robust to the inclusion of additional fixed effects and other influences, such as mergers and acquisitions, or geographic expansion. Moreover, I find that greater competition reduces banks' failure probability, share of non-performing loans and increases profitability. These findings suggest that competition increases stability, as it improves bank profitability and asset quality.

JEL Classification: G21, G28, G32

Keywords: Risk; Stability; Competition; Contestability; Entry; Lending

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