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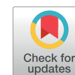
Does bank regulation matter on the relationship between competition and financial stability? Evidence from Southeast Asian countries



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A B S T R A C T

This study examines the role of bank regulation on the relationship between competition and financial stability. The considered regulations are capital requirements, activity restrictions, deposit insurance, and official supervision based on prior literature. We used data from the banking sector of Southeast Asian countries over the period of 1990–2014. Using system Generalized Method of Moments (GMM) and considering financial freedom and property right as instrumental variables, this study found that competition promotes financial stability, and reduces credit risk. Further, capital requirements and official supervision are the most effective and straightforward bank regulations promoting financial stability irrespective of the level of competition. Activity restrictions are effective in shaping financial stability only in a highly competitive environment, while deposit insurance promotes financial stability in a less competitive environment. This study provides a framework to determine the bank regulation best suited to promote financial stability through the channel of competition.

1. Introduction

Bank regulation, competition, and financial stability are three interconnected terms in the banking sector that have gained increasing attention among the policy makers and academics, especially after the 2008–2009 Global Financial Crisis (GFC), wherein regulatory oversight rather than unfettered competition is recognized as a pivotal cause of that crisis (Beck, 2008; OECD, 2010; World Bank, 2013; Schaeck and Cihák, 2014). The nexus of bank regulation, competition, and financial stability is first studied by Keeley (1990) who argued that deregulation in the U.S. banking market during the 1970s and 1980s increases competition which erodes the franchise value and profit margin of banks, and exacerbates their risk-taking behavior. On the other hand, Boyd and Nicolo (2005) argued that competition in the banking market reduces the risk-taking behavior of banks by driving them to lower the interest rate on loans. Yet, Martinez-Miera and Repullo (2010) claimed that the relationship between competition and financial stability is non-linear, because competition not only exacerbates risk-taking, but also increases the profit margin to build a capital buffer. To date, empirical studies have yet to reach a consensus on the effect of competition on financial stability in the banking sector. Rather, this issue has been intensified with conflicting theoretical predictions and mixed empirical results, especially after the GFC.[1] This has piqued the

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[1] Excellent reviews of both theoretical and empirical literatures on regulation, competition and stability nexus are reported in Beck (2008), Jiménez et al. (2013), Fu et al. (2014).

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interest of policy makers in the roles played by bank regulation in shaping the level of competition and its effects on financial stability.

Bank regulation is designed to mitigate the risk-taking behavior of the banks and sim to bolster a sound and stable banking system (Repullo and Suarez, 2013), because it's instability contaminates the entire financial system by shrinking credit facilities and distorting both interbank loan market and payment system (Khan et al., 2016). Indeed, bank regulation influences the level of competition which, in turn, shapes financial stability. One such regulation is activity restrictions, where less restrictions erode a bank's market power and increase competition, and exacerbate the bank's risk-taking behavior due to the 'franchise value effect' (Keeley, 1990). On the other hand, more restrictions also increase competition by reducing scope of operations and risk diversification, and may also motivate the bank to limit risk-taking behavior at certain level of competition due to the 'risk-shifting effect' (Boyd and Nicolo, 2005). Similarly, deposit insurance may increase competition by increasing the level of intermediation and building public trust in the banking system, and that changed competition may alter the influence of deposit insurance on financial stability. In a similar vein, the capital requirements may influence competition by preventing new entrants and protecting the market power of existing banks (Northcott, 2004), which may also shape financial stability. This means that the efficiency of bank regulations to limit a bank's risk-taking behavior or to enhance its financial stability is channelled through the level of competition. Therefore, the selection of bank regulation without considering the level of competition may result in regulatory failure which may destabilize the banking sector, and cause financial crisis as witnessed by both emerging and matured countries in recent decades.

The academic literature has yet to examine, empirically, how bank regulations, particularly capital requirements, activity restrictions, deposit insurance and official supervision, shape financial stability through the channel of competition. We believe that such an analysis offers significant regulatory policy implications for the banking sector as we stipulate the relationship between bank regulations and financial stability is complicated by the highly-concentrated market. This motivates us to study the nexus between bank regulation, competition, and financial stability of the banking sector.

In examining the nexus between bank regulation, competition, and financial stability, we are looking at a unique market for bank restructuring and regulatory changes which are more prominent in the banking sector of the old members of Association of Southeast Asian Nations or ASEAN-5, especially Indonesia, Malaysia, the Philippines, Singapore and Thailand based on the experience of the early 1990s deregulation, 1997–1998 Asian Financial Crisis (AFC), and 2008–2009 GFC. The banking sector in this region has gone through tremendous restructuring process including regulatory reform in the forms of capital requirements, activity restrictions, market discipline and official supervision in the aftermath of the 1997–1998 AFC and 2008–2009 GFC (Teo et al., 2000; Lee and Park, 2009). The post-crisis restructuring, deregulations and supervisory drives resulted in strengthening the capital base, risk management capability and earning capability (from Appendix A) which might enhance the financial stability in the region despite its highly-concentrated banking industry. Also, the Governors of ASEAN central banks have agreed to harmonize bank regulations as a pre-requisite of ABIF[2] in 2011 (Yamanaka, 2014). Thus, given the regulatory changes in the last two decades, ASEAN-5 provides an excellent case for examining the relationship of bank regulation, competition, and financial stability.

The study provides new empirical evidence for the regulation, competition, and financial stability nexus in the ASEAN-5 countries, in the context of emerging markets. This study covers the period from 1990 to 2014, which captures both deregulation and restructuring efforts in ASEAN-5 countries. To capture the regulatory framework, we have constructed indices for capital requirements, activity restrictions and official supervision, and a dummy variable based on the survey results of Barth et al. (2001, 2006, 2008, 2013a). We have measured competition using a new empirical industrial approach based on the methodology of Panzar and Rosse (1987), and financial stability using *Z*-score and non-performing loans (NPL) ratio. The study contributes to the existing banking literature by comprehensively identifying the set of banking regulations which work well in enhancing the financial stability in the banking industry, especially in emerging markets. Second, we believe that studying the moderating role of the bank regulation on competition and financial stability provides significant policy implications on the regulations that work best in achieving the economic objective of a more stable financial system given the highly-concentrated market setup that often leads to bank fragility due to excessive risk-taking and moral hazard behavior.

We have used the dynamic panel instrumental variable technique with the system GMM estimators using financial freedom and property right as instrumental variables to control for endogeneity, heteroscedasticity, and serial correlation in our study. The results show that competition is associated with greater financial stability, and lower credit risk. Capital requirements and official supervision work well in enhancing financial stability and reducing credit risk exposure with and without interacting the level of competition. Deposit insurance is effective in promoting financial stability and reducing risk taking behavior of the banks in general, but for those banks facing a less competitive pressure. On the other hand, activity restrictions are found weakening financial stability, and increasing risk-taking behavior of the banks facing a less competitive pressure. However, the destabilization effect of activity restrictions is found changed for the banks facing higher a level of competition.

The remainder of the paper is organized as follows. Section 2 reviews the literature on bank regulation, competition and financial stability. Section 3 discusses the methodology and the data used in this study. Results and discussion are provided in Section 4, while Section 5 concludes the study.

[2] ABIF stands for ASEAN Banking Integration Framework as a part of the ASEAN Economic Community which will be implemented in 2020 initially among the ASEAN-5, allowing the regional banks to expand cross border operations in other member countries with the status of local banks and enable them to enjoy home field advantage in the host counties.

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