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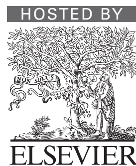

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Bank concentration, competition, and financial inclusion☆,☆☆

Ann L. Owen*, Javier M. Pereira
Hamilton College, United States

Abstract

Expanding access to financial services holds the promise to help reduce poverty and foster economic development. However, little is still known about the determinants of the outreach of financial systems across countries. Our study is the first attempt to employ a large panel of countries, several indicators of financial inclusion and a comprehensive set of bank competition measures to study the role of banking system structure as a determinant of cross-country variability in financial outreach for households. We use panel data from 83 countries over a 10-year period to estimate models with both country and time fixed effects. We find that greater banking industry concentration is associated with more access to deposit accounts and loans, provided that the market power of banks is limited. We find evidence that countries in which regulations allow banks to engage in a broader scope of activities are also characterized by greater financial inclusion. Our results are robust to changes in sample, data, and estimation strategy and suggest that the degree of competition is an important aspect of inclusive financial sectors.
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1. Introduction

Greater financial development has been linked to increases in average income as well as the reduction of income inequality. However, most of the empirical cross-country literature on the impact of financial development focuses on financial depth, using measures such as total outstanding deposits and credit to the non-financial private sector rather than the distribution of those financial services across households (e.g. Beck et al., 2007a, 2007b). Only recently have researchers turned their attention to questions of financial inclusion — the extent to which households and firms can access and make use of formal financial services (see Beck and Demirguc-Kunt, 2008 for a survey).

At the same time, the consolidation of banks around the globe in recent years and the increased scrutiny of banking regulation in the wake of the financial crisis have intensified the policy debates on the influence of concentration and competition in the banking industry on real sector outcomes (e.g., Beck et al., 2014).[1] Within this framework, an area of particular interest among researchers and policymakers has been the potential impact of financial market structure on access to finance. The traditional market power view argues that competition in the banking market reduces the cost of finance and increases the availability of financial services (e.g., Berger and Hannan, 1998). Alternative views argue that competition may have a negative impact on credit. One reason is that competition may interact with the level of asymmetric information in the market. This information hypothesis argues that competitive banking systems can weaken relationship-building by lowering banks' incentive to invest in soft information. Therefore, less compet-

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* Corresponding author at: Department of Economics, Hamilton College, 198 College Hill Road, Clinton, NY 13323, United States.

E-mail addresses: aowen@hamilton.edu (A.L. Owen), jpereira@hamilton.edu (J.M. Pereira).

[1] For example, between 1998 and 2013, the percent of assets held by the largest five banks in the United States increased from 32% to 47%.

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itive markets may be associated with more credit availability (Petersen and Rajan, 1995; Dell'Ariccia and Marquez, 2004). This explanation may be less relevant for the financial inclusion at the household level that we study, but a second alternative view relates bank size with greater opportunities for portfolio diversification. Larger banks may also be able to diversify loan portfolio risks more efficiently due to higher economies of scale and scope (Diamond, 1984; Boyd and Prescott, 1986). In addition, larger banks engaging in cross-border activities may obtain additional economies of scale and scope by geographic risk diversification.[2] Because theory does not unambiguously predict the relationship between competition and credit availability, the issue is ultimately empirical.

Our empirical results are consistent with the latter hypotheses in that we find that big banks are consistent with broad financial inclusion for households as long as the market remains contestable. We also find somewhat weaker evidence that countries in which regulations allow banks to engage in a broader scope of activities are also characterized by greater financial inclusion. Thus, the best policy for improving financial inclusion should focus on improving market contestability (as measured by pricing over marginal cost) rather than limiting the size and scope of banks.[3]

Interestingly, cross-country empirical research has focused almost entirely on access to finance by firms, a feature of the literature that may respond in part to the lack of sufficient and reliable aggregate level data on households until recently. Using data from a panel of 83 countries, our study is the first one to explore the relationship between the structure of the banking industry and households' financial inclusion. Measuring competition in the banking sector is challenging, and we rely on multiple bank competition indicators that proxy for market contestability and market power and relate these competition indicators to several different measures of access to finance by individuals.

Broad financial sector outreach is likely to be important for several reasons. For households, borrowing is an important way to cope with emergencies and to pay for household and social expenses such as water, health services and education (Peachey and Roe, 2006). Savings can also be an important way to smooth consumption from one month to the next and to cope with unexpected expenses.[4] Hence, borrowing and saving may be welfare enhancing even if not always output-increasing. For poor households in particular, financial market imperfections (e.g., informational asymmetries, transaction costs) can lead to financial constraints due to a lack of collateral, credit histories and connections.

In order to characterize banking sector outreach across countries, we rely on measures of actual use of deposit and credit services collected from the IMF's Financial Access Survey. Specifically, we employ indicators on the number of borrowers, depositors, loan and deposit accounts per 1000 adults. We interpret higher values of these measures as indicating the use of deposit and credit services by a greater share of the population and by clients with smaller savings and loan account balances. Our choice and interpretation of the measures follow that of Beck et al. (2007a, 2007b) but while the authors carry out their own survey at one point in time only, we benefit from a richer time-series data for a larger set of countries that allows us to explore the relation between different determinants and financial system outreach over time as well as exploit within-country variation of access to finance. We acknowledge that there are other banking services in addition to deposit-taking and lending (such as insurance services) as well as other financial providers beyond commercial banks, namely, microfinance institutions and cooperatives.[5] These are all natural avenues for future research, however, our current focus on commercial banks has the advantage of providing specific policy implications.

This paper adds to the still evolving literature on financial inclusion in general and financial outreach for households in particular. Efforts to examine how formal financial systems affect the poor remain inadequate with much of the action still revolving around country level studies which suffer from their own set of limitations — including very high costs of implementation and the concerns of whether results found in one specific socioeconomic environment can easily be applied to another. Only a few papers investigate the link for a large panel of countries but their emphasis lie on the effect of financial depth measures on inequality (see Demirguc-Kunt and Levine, 2009 for a review). We also add to the broader literature on banking sector competition and access to finance for firms. To our knowledge, we are the first study to employ a large panel of countries, several indicators of financial inclusion and measures of different aspects of bank competition to study the role of banking system structure as a determinant of cross-country variability in financial outreach for households. Our results are robust to a number of specification changes and suggest that the degree of competition is an important aspect of inclusive financial sectors.

The remainder of the paper is organized as follows. Section 2 provides a brief literature review. Section 3 discusses the data

[2] Dong et al. (2017) show that a banking sector with a small number of large banks is welfare-enhancing because with the entry of new banks, competition stimulates aggregate lending. As the number of banks increases, however, the banking sector's demand for funds grows which bids up the value of funds causing the deposit rate and thus the cost of bank lending to increase.

[3] As we discuss further below, we do not find a strong positive correlation between banking industry concentration and market power.

[4] Studies show that poor households often seek specific, structured financial tools to achieve their savings goals and refute the old prejudices held that poor households lack the surpluses to save much (e.g., Ashraf et al., 2006; Collins et al., 2009). For example, Collins et al. (2009) study the financial lives of poor households and find a common pattern of intensive use of saving instruments but relatively small average balances.

[5] Interestingly, Donou-Adonsou and Sylwester (2016) find for a panel of 71 developing countries over the period 2002–2011 that while banks have the ability to reduce poverty, MFIs do not, at least at the aggregate level. One possible explanation provided by the authors is that traditional banks facing competition from MFIs expand lending to the poor at lower costs (see Holden and Prokopenko, 2001; Thanvi, 2010). Authors also point out the much greater size of banks – thus having a greater potential for changes in their provision of financial services to affect the poor. In contrast, the scale of MFIs' lending is significantly smaller and thus their impact on poverty reduction would tend to be locally contained. Their work suggests that the trickle-down effect from financial development may not work for MFIs as it does for banks.

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