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Abstract

Using bank level measures of competition and co-dependence, we show a robust negative relationship between bank competition and systemic risk. Whereas much of the extant literature has focused on the relationship between competition and the absolute level of risk of individual banks, in this paper we examine the *correlation* in the risk taking behavior of banks. We find that greater competition encourages banks to take on more diversified risks, making the banking system less fragile to shocks. Examining the impact of the institutional and regulatory environment on bank systemic risk shows that banking systems are more fragile in countries with weak supervision and private monitoring, greater government ownership of banks, and with public policies that restrict competition. We also find that the negative effect of lack of competition can be mitigated by a strong institutional environment that allows for efficient public and private monitoring of financial institutions.

JEL Classifications: G21, L11, L14

Keywords: Systemic risk, bank competition, credit risk, merton model, distance to default, default risk, lerner index, bank concentration

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