Is there a competition-stability trade-off in European banking?

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Abstract

The trade-off between bank competition and financial stability has always been a widely and controversial issue, both among policymakers and academics. This paper empirically re-investigates the relationship between competition and bank risk across a sample of 54 European listed banks over the period 2004-2013. However, in contrast to most extant literature, we consider both individual and systemic dimension of risk. Bank-individual risk is measured by the Z-score and the distance-to-default, while we consider the SRISK as a proxy for bank systemic risk. Using the Lerner index as an inverse measure of competition and after controlling for a variety of bank-specific and macroeconomic factors, our results suggest that competition encourages bank risk-taking and then increases individual bank fragility. This result is in line with the traditional "competition-fragility" view. Our most important findings concern the relationship between competition and systemic risk. Indeed, contrary to our previous results, we find that competition enhances financial stability by decreasing systemic risk. This result can be explained by the fact that weak competition tends to increase the correlation in the risk-taking behavior of banks.

Keywords: Bank competition, Lerner Index, Financial stability, Bank-risk taking, Systemic risk, Competition policy
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