Financial intermediaries

Finance

Finance and Accounting of Institute Measures of Banking Competition There are several measures of competition that are applicable in the banking industry. They include the Structure-Conduct-Performance (PCP) paradigm, Panzar-Rosse H-statistic, the Lerner Index, the Persistence of Profits (POP) as well as the Boone Indicator. According to the SCP paradigm, the measurement of firm performance considers several indicators such as growth, efficiency, market share, technological progress, and profit. According to the paradigm, an industry with fewer firms makes it possible for them to exploit the market and charge higher prices, thus increasing their profitability. A drawback of the approach is that it is hard to observe bank conduct and that the approach excludes foreign banks in the determination of competition (Bell, Brooks and Prokopczuk, 2013 p. 197).

The Panzar-Rosse H-Statistic relates a firm's conduct with models of different market structures such as monopoly, monopolistic competition, imperfect competition or perfect competition (Schaeck, Cihak and Wolfe, 2009 p. 715). It demonstrates how the elasticity of a firm's revenue differs under the different market structures. Although the model is quite straightforward under monopoly and perfect competition, imperfect competition, and monopolistic competition pose some complexities for this approach. The H-Statistic also assumes equilibrium for the banking market in the long-run.

The Lerner Index uses the relationship between a firm's price and marginal cost as a basis for the measurement of the firm's market power. The index is a reciprocal of the price elasticity of demand and indicates the proportion price exceeds marginal cost. A disadvantage of the Lerner index is that it fails to demonstrate the substitutability of a product (Bell et al., 2013 206).

The Boone Indicator assesses, in terms of strength, the relationship between efficiency and performance. Accordingly, superior performance is achievable for more efficient banks. Under competitive market conditions, banks show more aggression in order to achieve the superior performance as compared to competitors (Bell et al., 2013 p. 206). The Boone Indicator does not share the disadvantages of the H-Statistic and the Lerner Index. It demonstrates the aggression more efficient banks employ in the exploitation of their cost advantage. As a measure of competition, Persistence of Profits proposes that entry and exit provide a sufficient avenue for the elimination of abnormal profits. Accordingly, profit rates for all firms would converge towards some average value in the long-run. For firms that can prevent entry, they manage to limit competition and thus continue to enjoy abnormal profits for as long as they can control entry (Bell et al., 2013 p. 207).

Among all the measures of competition, the latter ones, H-Statistic, Lerner Index, POP and Boone indicator, provide a better measure. However, they also give different results for the same set of data. To get a conclusive outcome, the measures need the support of various estimates and other factors such as economic development. That way, it would be possible to interpret the competition in the banking sector.

References

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