**INSTITUTIONAL AFFILIATION**

**ASSIGNMENT**

**STUDENT'S NAME**

**Option 2**

**C) Describe how competition in banking markets might affect:**

**• Access to bank funding and related costs for SMEs**

The link between bank market competition and SMEs' funding limits has sparked heated discussion. On the one side, the bank market competition hypothesis claims that, as predicted by a classic Industrial Organization model, greater market power in lending rates leads to fewer volumes and increased prices for borrowers (Scott, 2008). On the other hand, the evidence hypothesis (IH) predicts that as banks gain market dominance, they would spend more on their connections with SME borrowers, resulting in increased loan availability. For the first time in a developed nation environment, this study analyzes company and bank balance sheet data from across Europe from 2005 to 2008 to conduct cross-country assessments of the assumptions mentioned above. The data clearly show that bank market power is linked to reduced business investment and that this effect is caused by bank market power's negative impact on SMEs' financing restrictions. There is sufficient evidence that the influence of bank market power on financing limitations is largest among "micro" businesses when we looked into the possibly diverse effect of bank market power on financing constraints.

This conclusion is consistent with long-standing literature demonstrating that the smallest enterprises have the most difficulty acquiring external funding, owing to their lack of publicly available financial information ("opacity") and their increased sensitivity to idiosyncratic shocks. Finally, in the article's final section, the influence of a country's financial-economic structure on the connection mentioned above is examined. It is discovered that, in nations where the private enterprise is more dependent on banks on funding, the impact of banking market dominance on SME financing limitations and investment is magnified, as is the case in the United States. In Ireland and throughout Europe, the conclusions of the study by Bikker et al. (2007) are highly relevant to the current policy debates taking place. Several policies to stimulate SME finance have been implemented in the aftermath of the global financial crisis due to the negative impact of SME financing limits on business investment, hiring, innovation, and growth. These policies include tax breaks, tax credits, and other incentives.

The discovery of a negative impact of bank market dominance on small and medium-sized enterprise funding limitations justifies policy initiatives that attempt to encourage the entrance of new banks into local credit markets (Anand, 2006). To increase competition in the banking sector, measures such as the establishment of a state-owned small and medium-sized enterprise bank, public-private partnerships in which the government provides paired money for new entries to the Small and medium-sized lending market, the recruitment of foreign banks, and the reduction of entry barriers into the banking industry should be considered. According to the findings, bank-dependent nations have an even more significant negative impact on SME financing limits than nonbank-dependent countries. This result supports policies that try to broaden the funding sources accessible to SMEs. Some recent studies have revealed that Ireland's SME population is among the most dependent on banks in Europe, suggesting that this is a source of particular worry for Irish policymakers.

* **Economic growth**

One of the most well-established economic ideas is that competition is the ideal market structure. It promotes allocative and productive effectiveness, stimulates incumbent and new businesses to develop, and allows customers to buy goods and services at competitive prices, pick from various producers, and benefit society. However, competition can be impossible and harmful (Anand, 2006). Natural monopolies, patents, unique resource control, costs, and asymmetric knowledge, for example, are unable to achieve a competitive result, necessitating particular forms of intervention to improve market results. According to some economists such as Agénor (2004), competition in banking markets is likely to negatively affect their performance and stability, hurting both people and credit institutions and causing inescapable spillover effects on the whole economy.

Without a doubt, the great deal of people that use banks as well as their services today, specifically in developed countries, proves that banks which show that credit institutions' actions and decisions have a more significant and more immediate impact on the actual economy than other businesses (Anand, 2006). Given the widely acknowledged and critical role of banks in the economy now, particularly their position in credit supply and the transmission of monetary policy and the payment system, it is necessary to explore the effects of banking industry rivalry on economic performance. The economic literature has long focused on assessing and evaluating the competition or market strength in the banking business. Several theoretical and empirical research has recently focused on the role of banking market power in promoting economic development (Anand, 2006). Some authors have proposed that a higher degree of market power can increase the availability of information for banks in their lending activity and their willingness to engage in closer lending relationships with their clientele, contradicting the conventional view that less competitive banking industries reduce social welfare.

Several significant contributions demonstrate that, while competition increases the efficiency of banks' administration and the stability of banks, it does not always increase loan provision (Anand, 2006). Traditional empirical research has shown that young enterprises can borrow substantially reduced rates in the more concentrated markets, implying that credit availability may be greater in less intense competition than in more competitive ones. A sequence of seminal empirical literature that exploits the removal of growing restrictions to establish the impact of competitors in the market, see in the specific show that liberalization of branching tends to increase the threat of takeovers, which in turn induces bank managers to make efficient lending decisions have been published. Despite the increase in bankruptcies rates observed, competition has resulted in improved performance by banks. Although the liberalization of branching limitations appears to improve bank management, the research also shows that it does not increase loan provision.

**a) Consequences of Interest Rates near or Below Zero in Terms of:**

* **Bank Performance and Risk-taking**

Many banks have adopted significant conventional and non-standard financial policy initiatives since the financial crisis began in 2007, dropping interest rates to near-zero levels. Some banks, particularly the European Banks, have even employed negative policy rates to encourage post-crisis sectors characterized by poor growth and low inflation (Carbo et al., 2019). Negative interest rates are justified because they give additional monetary stimulation, supporting development and recovery to aim inflation.

Interest rates near zero, by boosting the economy, the Federal Reserve may improve the bank performance through a rise in loan demand, an improvement in asset quality, and a reduction in the riskiness of loans. Critics of negative policy rates, on the other hand, have raised two critical issues with the approach. First and foremost, negative interest rates might put a lot of pressure on financial institutions' profits. As a result, banks may lend to more risky borrowers (a practice known as "risk shifting"). Second, search for yield' among institutional investors might result in an unbalanced demand for high-yielding hazardous assets due to a lack of diversification (Carbo et al., 2019). If this is the case, the indicated asset price inflation might harm financial stability. It is still unknown which sorts of banks are considered more or less hazardous by the marketplace when interest rates are negative. Aside from that, it is presently unclear if cuts to negative interest rates are considered "exceptional," for example, because they are thought to have a different impact on financial stability than equivalent reductions to lower but non-negative rates. In this study, we resolve these concerns (Carbo et al., 2019). To do so, we investigate the risk effect of three sequential deposit facility rate (DFR) cuts by the European Central Bank (ECB) to negative values, each by ten basis points (bps) on July 6, 2013, October 5, 2013, and December 1, 2014, as viewed by the financial markets. Likewise, we investigate whether the impact of these reductions is distinct from the effects of a previous decline in the DFR from 25 basis points to zero on July 2, 2011.

An unconditional default risk metric, SRisk resembles market-based stress tests. Monthly risk assessments are provided for 44 publicly traded Eurozone banks. A matching approach is used to estimate risk for non-listed banks to assure a representative sample and include other institutions in our research(Fuhrer, 2017). The 67 unlisted banks are matched to the 67 nearby 'next-neighbor' banks with market data. All 111 banks' accounting data is used in the matching process. Outright Monetary Transactions announcement in August 2012 may have triggered the euro area's dramatic decline in risk between mid-2012 to mid-2014. Still, the steady rebound in economic growth and rising bank capital buffers also had a role. The three DFR drops to negative rates have had a relatively small(er) impact, given the significant range in the degree of risk for all banks. In a future stress scenario, banks' danger of being undercapitalized is one of our primary concerns (Fuhrer, 2017). If the world equity index drops by 40% in the next six months, a bank's expected capital shortage equals risk. A bank's equity market value, leverage ratio, variability of its share price, and correlation of its stock price with the global index are used to estimate the metric.

A drop to a progressively negative rate, certain banks, but not all, are seen as riskier, i.e., more likely to become underfunded in a future financial crisis, using panel regressions. The business models of banks determine the risk impact. Banks with well-diversified revenue streams are seen to be lesser (systemically) hazardous. Negative interest rates appear to help such institutions in the long run. On the other hand, markets view banks that primarily rely on deposit funding as possibly riskier. The observed heterogeneity is consistent with earlier research that claims that bank characteristics become a crucial predictor of monetary policy transmission at negative rates.

Finally, in June 2013, a 'placebo' DFR drop from 22–25 bps up to zero elicited different SRisk reactions than then went below 0 in 2014 and 2015. This shows that damaging rate cuts are exceptional,' in the sense that they will have a distinct economic security impact than non-negative rate cuts (Fuhrer, 2017). When only listed banks were included in the sample, our regression findings remained qualitatively comparable. In this instance, however, the differential effects become statistically negligible. As a result, the findings for non-listed banks must be regarded as provisional.

* **Bank Lending**

A low-interest-rate environment is beneficial for many stakeholders in the economy because their regular payments are reduced. Prospective buyers may also be enticed to enter the market even by cheaper pricing (Krippner, 2012). Low-interest rates allow clients to spend more of their hard-earned cash. As a result, the demand for everyday items will rise due to increased spending and borrowing. Because of this, banks may now extend more loans (Kim, 2010). Enterprises can also benefit from the environment by making large purchases and expanding their available cash.

As long as lending rates remain unusually low for an extended period, they have advantages and disadvantages. Investing in some savings or a similar vehicle has a limited return in this environment due to the influence of cheap borrowing rates (Kim, 2010). Because lending rates will be lower, loan payments will be lower, too, but bank earnings would suffer more. People's desire to take on the debt will grow during these periods, which might be a problem for consumers and banks when interest rates rise.

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