Concentration in the Banking Industry

Good or Bad?

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High Concentration

- High concentration within a market is typically not a desirable quality.
- It tends to lead to higher prices, lower outputs and a smaller consumer surplus even in the absence of collusion.
- Firms in highly concentrated markets often sustain high profits for long periods of time.

What about banking?

- In many industrialized countries banking is a highly concentrated industry.
- The top three banks in:
  - Finland control 85% of the market.
  - Norway control 84% of the market.
  - New Zealand control 77% of the market.
  - South Africa control 77% of the market.

  (Beck, Kunt, Levine 2003)

What about Banking? (cont)

- The United States has a relatively low concentration in comparison to many other nations, our top three banks capture only 19% of the total industry (Beck, Kunt, Levine 2003).

So what does this mean??

Is it a good or a bad thing?

Concentration can be a good thing!

- Because of the potential losses from a breakdown of the banking system, concentration in the industry can be good in a few critical ways.
- A study done by the National Bureau of Economic Research found that high concentration leads to high stability in the banking industry.
- They found that a concentration level of 72% or above was directly correlated to fewer occurrences of banking failure within that nation.

Concentration as a Benefit

- The three principle benefits of high concentration:

1. Banks of large size are easily diversified. This allows them to adjust in other sectors of the market when one sector takes a turn for the worse.
   - A smaller bank that focuses on one or two sectors of the industry is highly vulnerable to fluctuations within those sectors.

Concentration as a Benefit (cont)

2. High concentration levels will increase profits for the dominant banks within the industry.
   - While this may lead to higher interest rates and fees it will also insulate banks from economic shocks.
   - Also, with higher franchise values banks will have less incentive to take financial risks in pursuit of profits (Helen, Murdoch, Stiglitz).

Concentration as a Benefit (cont)

3. Larger banks are more easily monitored than many small banks.
   - It is easier for a regulatory commission to look after a few large banks then many small ones.
   - Systems within each of the large banks will be similar rather than having to learn the systems of many small banks.

How do we fit in?

- As was mentioned, the United States has a low concentration level in our banking industry.
- According to Allen and Gale (2000) this is in part the reason that the US sees more economic fluctuation than other more heavily concentrated countries.

The NBER paper

(National Bureau of Economic Research)

- NBER paper #9921 written in 2003 found that there was a significant negative correlation between bank size and banking failures.
  - As the size of banks went up, the amount of banking failures decreased.
  - A one Standard Deviation increase in bank size led to a 1% decrease in the chance of bank failure.
  - The chance of a bank failure across the entire study was only 4%, so these finding are significant.

There are some negative effects.

- As in almost any industry, high concentration will lead to low levels of competition and higher prices, this is no exception.
  - Higher interest rates are often the byproduct of high levels of bank concentration.
  - This is particularly bad for investors as it makes investment far more risky.

There are some negative effects. (cont)

- Some niches within the industry are likely not to be filled.
  - The large banks will focus on the most profitable niches and may neglect those that are less profitable.
  - This can be compared to the airline industry. Large airlines will fly the most profitable routes while small airlines will fill in the blanks. (Barth et al. (2004))

Conclusion

- Even taking into account the negative attributes of a highly concentrated banking system, the NBER still found that it led to increased stability.
- If you think about it, this makes perfect sense!!
  - The more market power that a firm has the more likely it is to obtain higher than normal profits. This will undoubtedly lead to greater stability for that firm, this is nothing new.

So what should be done?

- Perhaps a more interesting question would be weather or not increased stability is worth it.
  - We know that the potential loss from a major banking crisis could be astronomical.
  - However, we will undoubtedly pay higher interest rates with fewer banks leading to greater risks for investors.
  - Is the loss from higher interest paid and greater investment risk smaller than the gain from increased stability?

☺ Not even the NBER could tackle that question!