Problem 3.

Without relying explicitly on formal models, you are asked to provide arguments in favor and against more competition in the banking industry.

Traditionally competition among firms will create efficiency, except where the fixed costs or increasing return to scale naturally gives rise to monopolies. There is of course a need for some competition among banks because the only way to discipline banks is to take your money elsewhere. Hence competition is needed for the threat of bank runs to be credible.

In the banking sector, however, increased competition will possibly create unwanted noise because of asymmetric information. The depositors are risk averse and prefer zero risk. Transparency in the banking sector would easily let depositors choose the banks with the lowest risk, and competition would give an efficient market solution. But transparency is hard to obtain in real life, and would come at a cost. As we know from standard economic theory, free competition and free entry would run the price down and profits net of fixed cost would approach zero. Hence the discounted value of all future profits, the charter value, is lower when competition increases. Since the banks pay a given rate of interest on deposits the banks keep all of the excess returns. That is all the returns above its obligations to the depositors. Thus, under competition, the downside risk for the banks decrease, the value of still being in business is low, whereas the upside risk is limitless. So under more fierce competition banks become more myopic, and would like to take on higher risk today.

If full transparency is not feasible, bank managers are subject to moral hazard, the depositors can no longer observe the risk undertaken by the banks. The bank managers will then take on more risk. This leads to an efficiency loss.

The screening intensity of the banking sector will also be adversely affected by competition. If you are a bank and experience tough competition, you are willing to cut your margin on the best of your customers. It is easy for a bank to price discriminate between its customers, and thereby offering lower interest rates to its safest loan takers, the ones with which they have a long, good history. Hence entrants in the banking industry are only able to steal the customers the incumbent banks do not really want- or at least their marginal customers. Projects that would have been rejected in one bank may now be funded in another. Thus more banks would increase the total number of projects getting funded, even beyond the efficient level of credit supply.

More competition in the banking industry will both lead to efficiency losses and gains. How this outweigh each other is hard to say, but history suggests that more competition among banks may lead to larger efficiency losses because of asymmetric information and risk neutral bank managers. (F&R 3.5.1). There are, however, clear <u>theoretical</u> arguments in favor of restricting the entry into the banking sector. This is also what is being done all over the world today.

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