# Seminar 2 -- Economics of Banking

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

## In favor of more competition in the banking industry:

Competition in banking can be beneficial for the clients. Indeed, the bank industry must be considered by the same way we consider any other industries. Every client is specific because he has his own needs in terms of banking demand, which are different from another one's. In this case, competition is a good mean to diversify the supply among banks. Competition in banking consists in providing the clients with the most customized service in order to better meet their needs. If the service provided by a bank does not suit the client's needs, nothing can prevent him from changing his bank to find the most adapted characteristics he is looking for. This is quite an important goal of the banking competition. In contrast, oligopolies are inefficient and serve consumers badly.

The common wisdom would hold that restraining competitive forces should produce welfare losses. Banks with monopoly power would exercise their ability to extract rents by charging higher loan interest rates to businesses and by paying a lower rate of return to depositors. Higher lending rates would distort entrepreneurial incentives toward the undertaking of excessively risky projects, thus weakening the stability of credit markets and increasing the likelihood of systemic failure. Higher lending rates would also limit firms' investment in research and development, thus slowing down the pace of technological innovation and productivity growth. Lower supply of loans, associated with higher lending rates, should also be reflected in a slower process of capital accumulation, which will slow the overall economic growth.

To sum up, more competition in the banking industry is welfare-enhancing.

## Against more competition in the banking industry:

The severity of today's financial crisis is blamed by some on the pressure of competition among banks. Lifting of restraints, such as interest rate caps on deposits or rules that prevent banks from operating in certain markets, leads to more intense competition. That is good for borrowers, but it also hurts banks' profit margins by reducing the "franchise value" that comes from expected earnings.

A diminished franchise is not only bad for shareholders. By reducing the stake that banks have in their own long-term survival it may make bank failures more likely. A bank that could look forward to a stream of profits in a sheltered market would be careful to lend prudently to avoid a bankruptcy that would destroy the franchise. But a bank earning only lean and uncertain margins on loans may have little to lose by gambling on riskier ventures. If these paid off, the bank would benefit. If they did not, depositors or government would pick up the bill.

Where competition leads to more risk-taking, the correct response is to monitor banks more closely. It would be better to make banks build reserves in good times and force them to match their tangible capital with their risk-taking appetite.

**References:**

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