In this short essay we will discuss the different arguments in favor and against more competition in the banking industry and explain why neither perfect competition nor absolute market power is the best solution.

First of all, from an economic point of view, the banking sector should be as efficient and stable as possible since it provides functions that contribute to social welfare such as the provision of financial services necessary for firms and consumers to undertake their business and thereby contributing in great deal to economic growth. There is however a tradeoff effect between efficiency and stability in the banking industry when looking at the level of competition.

In traditional economic theory, perfect competition leads to a commodity (credit) being offered at marginal cost, thus a higher supply of commodities (credit) at a lower cost for the consumer. So far so good. However perfect competition in the banking industry results in costumers shopping around for the lowest price and banks knowing that they will probably have their customers for a short period of time, therefore trying to squeeze the most out of every customer. The result is less relationship banking where loans are granted on potential future profit of a banking relationship knowing that the entrepreneur will be loyal to the bank. Instead transactional lending known as arm-length finance plays a central role. Since there is competition for every potential customer and the banks do not have data on all of the applicants, the bank will set a higher interest rate to compensate for the risk of a pool of risky applicants, which we know as the adverse selection problem. As we have seen earlier, a higher interest rate makes the good borrowers to choose not to invest in a project, while the bad borrowers will have an incentive to take on riskier projects and therefore the problem of moral hazard occurs.

When the banking industry is less competitive and the there exist some degree of market power there will be fewer banks, but on the other hand they will have a wider sector knowledge and this is in favor of the borrowers that have no financial assets but a potential good project in the long run. The bank will take into the account the future profit of the project and therefore be willing to finance the project since the entrepreneur cannot easily move its loan obligations to a competitor. It may therefore be beneficial for the economy as a whole from an efficient point of view that relation ship lending is the one that is practiced.

Another point of interest is whether it exists economies of scale in the banking industry? There is reasonable to think that it may occur such a benefit of being. This can be argued in the example of screening since the screening activity is costly. With many banks all the banks have to monitor all the customers, while in the case of monopoly the screening activity will only be performed once, thus reduces total social cost.

With imperfect screening we can think of a scoring or monitoring system, which the banks use to consider a loan application. There is little doubt that this system is imperfect. If it had been perfect we wouldn't have any losses in the banking industry. If we can think of a system, which with good accuracy says that an applicant is creditworthy, if that applicant is creditworthy the applicant will get a loan. The applicant will not only get one offer, he will get a loan offer in every bank since the applicant passed the system. So if we have infinity numbers of banks everybody will by principle get a loan since you can try an imperfect system infinity number of times. Then we can argue that fewer banks will have better risk portfolios since they have better control of all the applicants and reduce the possibility of a bad borrower to be granted a loan. Within a world of perfect competition the applicants will be able to apply for a loan in so many different banks that he will in the end manage to fool the system and get a loan as a result of the imperfect screening.

The probability of a bank experiencing shocks comes from how risky the banks behavior is. Since the banks typically have low equity, and many of the banks debt holders are small depositors with little possibility to monitor the banks behavior, banks have incentives to engage in risky behavior. If the risks pay off, shareholders will benefit, while if it fails, depositors take most of the cost.

If a banks market power increases, the bank will get higher margins and thus higher future profits. These expected higher profits will increase the banks alternative cost of bankruptcy, and thus lead to a less risky behavior.

By increasing the capital requirement in banks, you also indirectly reduce this incentive to take high risks, by increasing loss to shareholders of a bankruptcy. However there is a conflicting effect, because higher capital requirements will lead the banks to increase the interest rates of deposits to expand their deposit base. This will reduce future profits of the banks thus reducing the alternative cost of bankruptcy as explained in the previous paragraph.

Another way of mitigating this problem is by requiring the banks to disclose information on the riskiness of their portfolios. The customers of the riskier banks will then demand a higher interest rate on their deposits to be compensated for the higher risk of bank failure. This will increase the cost of having a riskier portfolio. If we think of a world with flat interest rate there will exist only one type of portfolio. If one bank portfolio is riskier then another, the most risky bank won't get any deposit with same interest as the less risky bank. Then there will only be one big bank or many similar banks with the same risk portfolio. But since people are indifferent when it comes to risk, there will always be an option to take more or less risk. Then it will always be a market with different interest rate.

With a bank failure an important concern is whether this banks failure will affect other banks in the financial system. With many smaller banks, as in the perfect competition situation, the shock is spread among many banks, lowering the cost of the shock to any one bank. If you have few large banks the shock of one bank failure

will be more severe, at least in the region where the bank facing the failure is the biggest.

From these arguments it seems that none of the two extremes, monopoly vs. perfect competition, is socially optimal.

Reference: http://dsp-psd.pwgsc.gc.ca/Collection/FB3-2-104-24E.pdf