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Too Many Banks, or Too Few?

The evolution of the U.S. banking sector has led to some incongruous outcomes.

In the wake of the three large U.S. bank failures we experienced this year, the American banking industry is facing a series of questions. One of them focuses on the structure of the sector: some say that we have too many banks, while others say there are too few. Both camps are partly right.

In 1980, there were more than 14,000 banks operating in the U.S. Throughout American history, there has been a distrust of concentrated financial power: regional centers have always been concerned that New York-based institutions would not meet their credit needs. (On a side note, this sentiment was a driving force behind the design of the Federal Reserve System, which has branch banks distributed across the country.)

The landscape of the industry was preserved by laws and regulations that limited mergers, branching and competition. As an example, deposit rates were capped by federal rules until the early 1980s. This ensured good profitability, but limited credit extension, innovation and efficiency. Banking operated by what became known as the rule of threes: 3% was offered for

deposits, which were lent out at a 3% spread. And bankers were often on the golf course by 3pm.

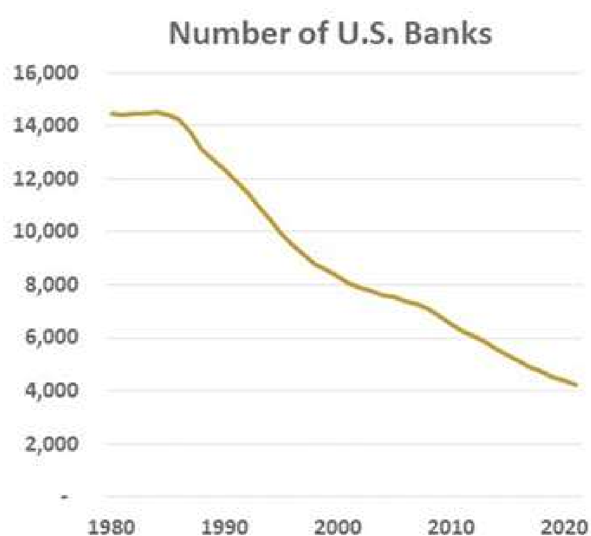
Having a lot of banks had some broad benefits, though. Deposits were widely dispersed, and most were covered by FDIC insurance. Further, periodic failures amid such a large community of institutions would likely not be systemic.

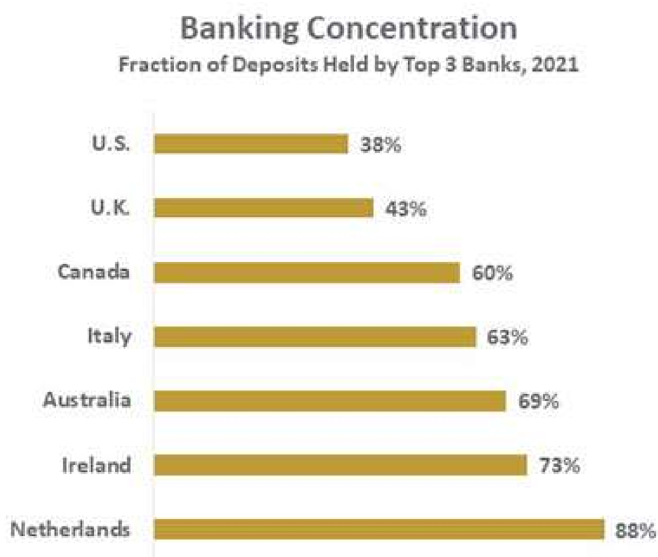
The interest rate spikes of 45 years ago disrupted this reverie. Market-based products emerged to provide competition for deposits, paying several times the rates that banks offered. Banks had lent out money for long terms at fixed rates, leaving their margins exposed to interest rate risk. Some never survived the shock; more than 4,000 U.S. financial institutions failed during the 1980s.

In that case, there was no safety in numbers. When many institutions have the same vulnerabilities, financial instability becomes more likely. So to form a more perfect industry, regulators began to encourage mergers. The number of banks in the U.S. has contracted steadily for 40 years, thanks largely to business combinations.

Larger firms were better able to invest in technology, improving efficiency. Geographic diversity in loan portfolios improved, reducing systemic risk. Bigger became better.

But then came 2008, when large banks were at the center of the crisis. In the wake of that episode, global significantly important financial institutions (G-SIFIs) were singled out for higher capital requirements and heightened monitoring. New mergers were viewed with a jaundiced eye; there have been almost no combinations among large banks in the past fifteen years.





Sources: FDIC, Bankscope

To focus attention on the G-SIFIs, mid-sized banks were given a somewhat lighter supervisory touch in 2018. Unfortunately, three mid-sized banks met their ends in March and April of this year. Larger banks were seen as safe havens during that interval, reversing the reputations earned during the Global Financial Crisis.

So the question of ideal industry concentration is back on the table. America still has more banks per capita than other countries, and the top three U.S. banks have a relatively modest market share. Yet J.P. Morgan Chase now controls more than 10% of industry deposits, a threshold that Congress established to prevent excessive consolidation. By some measures, we have too many banks; and by others, we have too few.

Recent banking stress is prompting a reevaluation of how systemic problems form and what kind of oversight is needed to prevent them. As regulation is once again recalibrated, both wide angle and close-up lenses will be required for effective surveillance.

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