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Concentration vs. competition: Is 4,000+ banks too many for the US, or just right?

Article

What we're thinking about: **The US is home to over 4,700 FDIC-insured banks.** It's not far off from the EU, which has 5,171, but stop and consider that the EU consists of 27 countries. The

UK currently has 365 banks, and Canada has 83.

Why does the US have so many banks, and is this staggering number a good or bad thing?

A brief history lesson: Two schools of thought emerged when the US was founded regarding the construction of its banking system.

- Alexander Hamilton called for one dominant national bank while Thomas Jefferson advocated for a decentralized, state-centered system. At the onset, national banks became the norm.
- Over time, people began to question if they could trust such enormous entities—consumers feared bigger banks would take advantage of certain customers, like farmers and small businesses. To protect their communities, many states passed legislation requiring banks to operate out of only one building—thus creating community banks.
- The new law led to the existence of over 30,000 banks in the US during the 1920s. But liquidity pressures often led to their collapse, and communities would lose everything. To make matters worse, the failure of one bank often sparked contagion to other community banks.
- The community banking system regained some stability in 1934 when the FDIC introduced deposit insurance up to $2,500 for all deposits at all banks. Community banks were better able to compete with larger banks because they were perceived as safe.

Over time, the state-focused legislation was peeled back, and the number of banks in the US dropped. But many community banks still thrive today.

Why are community banks good? Proponents of community banks argue that they're vital to the areas they serve, and that their existence promotes competition within the US financial system.

- **They know the community:** Smaller banks tend to know the communities they serve very well. They provide better customized and personalized products and services than federal banks with no ties to small communities.
- **Competition breeds benefits:** Standing out in the crowd requires banks to be more innovative and to create new offerings that consumers find valuable and can't get elsewhere. It also creates efficiency and lowers costs—banks that are inefficient and experience high costs are crowded out of the market. It also leads to lower-cost options for consumers, as high-cost providers will also be crowded out.

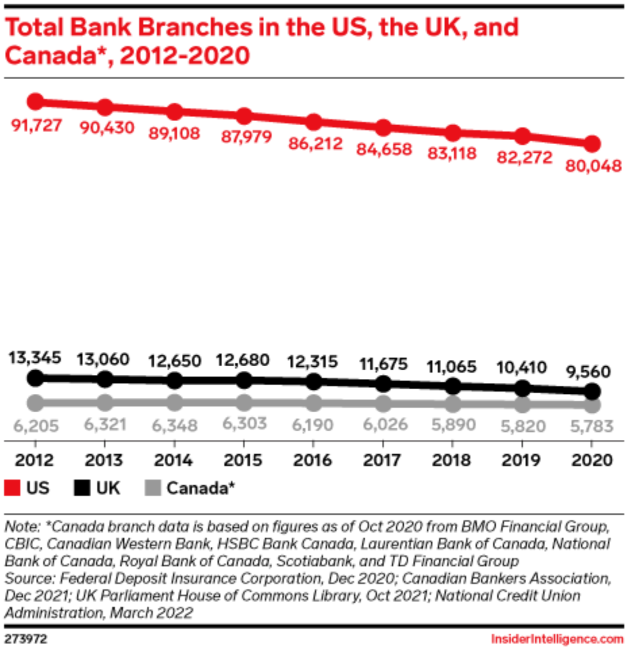
Can community banks be a bad thing? Their strength is also their weakness. Though they provide value in very specific ways, sometimes their specificity can lead to broader issues. Other risks also accompany community banks.

- Because they make it easier for a variety of consumers to obtain credit, they hold a lot of loans. But this can lead to issues like those that caused the subprime mortgage crisis in 2008. Now all eyes are on community banks' concentration in commercial real estate loans.
- Their smaller size also makes them more vulnerable to shocks in the financial system. They're typically less liquid and aren't usually as well-capitalized as major banks.
- And when shocks do occur, it's very easy for contagion to run through the community banking system, as we're seeing with the domino effects of four regional banks collapsing and others struggling to stay afloat.

The big takeaway: Though researchers have tried to determine if a concentrated or a competitive banking system yields better results for the economy, they haven't been able to make a solid case for either side.

- One study showed that regulations promoting competition within the banking system resulted in less instability within the system.
- But the same study showed that concentrated banking systems have better-diversified banks, which may provide a link between concentration and financial system stability.

Several different factors are contributing to the current instability of the US banking system, and it's hard to tell if these same factors would have the same effect on a more-concentrated financial system. But as more community banks face trouble, it's likely we'll see intense scrutiny of these smaller institutions, more regulation aimed at them, and potentially a massive outflow of deposits into larger banks.



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