NoteWorthy

Consolidation in Banking

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Bank mergers are big news these days, with each new deal seemingly topping the last in scale and scope. In fact, the recent mergers that have attracted so much attention are part of a longer trend going back nearly 20 years. This trend has been accompanied by a series of changes in state laws and federal regulations that limited the ability of banks to expand. These legal changes culminated with the Riegle-Neal Interstate Banking Act of 1994, which allowed full interstate bank branching. It is tempting to conclude that the removal of branching and other restrictions explains the large number of consolidations. But to a considerable degree, state legislatures and the U.S. Congress were responding to pressures from banks wishing to pursue mergers. What are the underlying economic forces driving this trend?

One popular hypothesis is that individual banks merge in order to increase their market power, and it is true that national market shares have been steadily increasing in banking. Nevertheless, banking is still relatively fragmented nationally and is much less concentrated than many other major industries. More importantly, banking is still predominantly a local service, and measures of concentration at the local level have been virtually constant for the last two decades. The reason is that mergers have generally occurred across local markets rather than within them – no accident, given that federal bank regulators scrutinize every bank merger for its effects on local concentration. Additionally, as long as new bank entry into particular local markets is largely unrestricted, competition should prevent abuses of market power and ensure consumer choice. In the last five years more than 650 new banks have been chartered throughout the United States, which intensified competition in many markets.

So what is driving the merger wave? Most likely, the extraordinary progress in communications and data processing technology over the last two decades is the single most important underlying force – hardly an original insight but a powerful one. For instance, the introduction of database-management software automated the record keeping at the core of the banking business. The development of personal computers and the software that manages networks made it possible for banks to provide widespread access to their records at branches and automated teller machines. The cost savings from these advances arise most significantly in the management of very large databases. In other words, the benefits of the technology revolution accrue most fully to very large-scale banks. Moreover, the ability to share customer and product information via computer networks has greatly lowered the cost of maintaining far-flung branches and of operating centralized call centers. All this has increased the relative advantage of being a big bank.

Although technological considerations appear paramount, there are certainly other factors affecting bank decisions to merge. For example, the ability to market a broader mix of financial services jointly motivates some combinations. While such special factors play a role in specific merger opportunities, the implications of technological progress apply across the board.

Beyond the direct effect of consolidation on particular states and cities, however, keep in mind that the technological advances I have just described in conjunction with the demise of branching restrictions have greatly increased potential banking competition – and the benefits that result from it – in all local markets. It is now not only legally permissible, but also operationally feasible for any bank in the United States to establish a presence in any local market. With this openness, competition and diversity of choice should increase, even as the national banking industry consolidates.

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