Performance Implications of New Competition

Duane B. Graddy, Associate Professor, Department of Economics and Finance, Middle Tennessee State University, focuses on the basic definitions of "banking markets" and "cluster of services" under deregulation. New entry by thrifts, particularly into smaller banking markets, Graddy predicts, may not necessarily produce lower prices and greater efficiency.

Recent legislative reforms and an array of financial innovations have drastically altered the competitive relationship among financial intermediaries. Traditional banking-type services are now offered by mutual savings banks, savings and loan associations, credit unions, investment companies, brokerage firms, and even some large retailers. As these institutions realize their full competitive potential, substantial restructuring is likely to occur in local financial markets. Economic theory suggests that this restructuring process will affect market performance (the overall function and efficiency of the market).

This restructuring process begins with the granting of the new powers and proceeds to changes in the number and/or size distribution of competing institutions and finally to new rivalries among those institutions. Traditionally, regulators have differentiated commercial banks from other financial institutions by the specific "cluster of services" they offered. But what is the "market"? Do banks compete only with other banks? Should thrift institutions be included in the definition of the banking market? What about money market funds? Can we even define a geographic market? Or, is it necessary to unbundle the entire cluster of banking services and develop a series of product markets which encompass various geographic regions? It is my feeling that the "cluster of services" paradigm is still applicable to the small market setting.

The nature of market rivalry determines prices and profits within local banking markets as well as the other performance dimensions (efficiency, stability, innovation, and equity).

"Can we even define a geographic market?"

For example, the successful entry of savings and loan associations into consumer installment lending could lower borrowing costs, increase loan output, reduce interest margin

variability, produce innovative changes in loan contracts, and/or create greater equity in the distribution of personal loans. On the other hand, the conduct of banks already offering consumer installment loans would not change if they had already established an effective barrier to entry.

Will More Competitors Mean Lower Prices?

Entry of thrift institutions into previously prohibited areas has the potential for reducing market concentration (increasing the number of competitors). Whether this change in market structure actually improves market performance, however, depends on several factors.

1. The first is the relationship between concentration and bank behavior. Are the performance dimensions (efficiency, stability, etc.) affected by the degree of local market concentration?
2. Second, have other nonbank intermediaries offered substitute products in the past? For example, bank response to the newly granted consumer lending powers is likely to vary considerably between markets where credit unions and finance companies have been active and where they have not.
3. Third, to what extent will thrifts choose to diversify into banking activities, and to what extent will the public perceive them as "full service banks." Can thrifts overcome the barrier of long-standing customer relationships and the wide menu of services offered by commercial banks? Even small banks can represent formidable competitors in this respect, particularly if they are affiliated with a large banking holding company (BHC). This brand-image problem may represent one of the most important hurdles facing thrift entrants.[1]

Many local banking markets, particularly rural markets, are characterized by high levels of deposit concentration.[2] Moreover, studies show that for two of the new thrift services, auto loans and checking accounts, the level of concentration is often high enough to allow suppliers to act together as a monopoly.[3] Bank interdependence in these markets is pervasive enough that profits are spread evenly over all competitors, and there is little or no incentive to lower prices for these services.

At the other extreme, there are few markets for these services in which the prices do not fall when concentration declines. Allowing thrift institutions to enter these product-lines appears to be an unambiguous way of benefiting consumers. However, this may not happen in every market. For example, thrift entry in a highly concentrated market may not lower the level of concentration enough to promote competitive pricing; thus it may have no long-term impact on service prices. Initial entry could create a flurry of different pricing patterns, but in the long-run, the market would return to a shared monopoly.

Pricing Strategy

On the other hand, product prices may decline if established banks lower their prices to a level that would make new entry unprofitable. To overcome the initial identity barrier, thrifts may have to spend heavily for advertising and physical facilities. Where mutual interdependence is high, established banks can discourage thrift entry by charging a price below that necessary to cover penetration costs.

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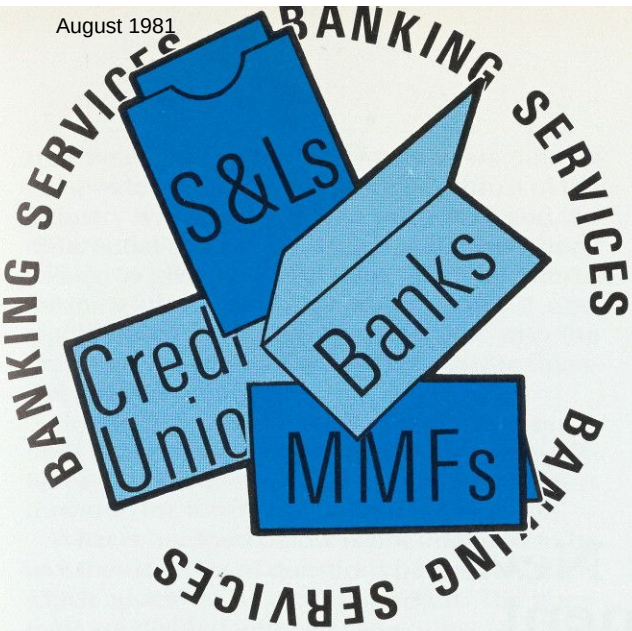
Through such a strategy, banks could undermine the ability of thrifts to establish lasting customer relationships as well. The failure to offer even some marginal service could destroy the "department store" effect. In cases where concentration is reduced below the effective monopoly level or where the market is not effectively monopolized, we would expect the entry of nonbank competitors to increase consumer welfare by lowering service prices.

[1] Studies show that firm entrenchment based on close customer relationships and variety of services inhibits concentration changes in local banking markets. See B. Frank King, "Changes in Seller Concentration in Banking Markets," **Working Paper Series**, Federal Reserve Bank of Atlanta, 1977.

[2] In this context, "banking market" refers to counties and SMSAs.

[3] Arnold A. Heggestad and John J. Mingo, "The Competitive Condition of U.S. Banking Markets and the Impact of Structural Reform," **Journal of Finance**, June 1977.



The granting of the new thrift powers presents a rare opportunity to analyze the price adjustment process among financial institutions in markets with different initial concentration levels. Do prices converge to a uniform level over time? If so, what market interactions produce the convergence? Rigorous competition? Tacit collusion? Price leadership? (One large competitor sets the price and the rest follow.) Will commercial banks' inherent advantage as the earliest full-service institutions produce a permanently fragmented price structure with the new competitors unable to overcome the banks' advantage? Banks have an accumulated stock of advertising and goodwill created over many years of full service operation. Does the process change if BHCs are present in the market? Recent evidence indicates that BHCs may reduce market rivalry.[4] So market consolidation could be detrimental to performance.

Nonprice Strategy

Nonprice competition (advertising, banking hours, gifts, etc.) is likely to intensify during the transition phase of the deregulation process for several reasons. First, price constraints still exist on certain services, such as time and savings deposits. The "premium controversy," which centers on whether premiums are an awkward and inefficient way to compete, attests to this. State usury laws on credit card loans may be prohibitive as well. Second, establishing the full-service image may require large promotional expenditures by S&Ls and credit unions. Third, given the more liberal branching status of thrifts in some areas, pre-emptive entry could be viewed as a way of forestalling future bank expansion. As deregulation proceeds and we move toward explicit pricing, the flow of resources may be redirected from promotional activities to production. However, even this is not clear. Consolidation within the financial services sector brought about by deregulation could produce a structure similar to that in other oligopolistic industries where prices are rigid and competition is on a nonprice basis.

A final consideration is the influence of market concentration on the risk/return trade-off in banking. The rate of return on bank assets is higher in concentrated markets than in less concentrated ones.[5] Moreover, bank managers tend to become more conservative as concentration increases. The result is that they reject more risky consumer loans, mortgages, and small business loans. At least one study, however, provides evidence that nonbank competition may reduce this conservatism.[6]

Increased competition may also influence the risk/return behavior of the banking firm by altering the costs and relative composition of the funding mix. Banks in concentrated markets exercise their monopsony power (the power of being one of few buyers in a market) by paying lower deposit rates and substituting demand deposits and passbook savings for other sources of funds.[7] The earnings squeeze caused by increased competition from thrifts and extra-market institutions could weaken the capital base of these firms. The deposit structure's interest sensitivity is a problem for all institutions. Banks affiliated with holding companies may fare somewhat better since they can rely on the financial strength of the consolidated organization. ER

—Duane B. Graddy

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[4]Stephen A. Rhoades and Roger D. Rutz, "Impact of Bank Holding Companies on Competition and Performance in Banking Markets," **Staff Studies**, Board of Governors of the Federal Reserve System, 1979.

[5]Arnold A. Heggestad, "Market Structure, Risk, and Profitability in Commercial Banks," **Journal of Finance**, September 1977.

[6]Donald R. Fraser and Peter S. Rose, "Banking Structure and Performance in Isolated Markets: The Implications for Public Policy," **Antitrust Bulletin**, Fall 1972.

[7]Duane B. Graddy and Reuben Kyle, "The Simultaneity of Bank Decision-making, Market Structure, and Bank Performance," **Journal of Finance**, March 1979.