FRBSF WEEKLY LETTER

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Bank Entry and Deregulation

Commercial banking in the United States is a highly regulated industry. Banking regulations pervade almost every aspect of the business, including whether, how and where a bank can do business. Ostensibly, the primary rationale for banking regulation is to protect and promote the safety and soundness of the financial system. Indeed, as bank failures have mounted recently, some have called for a reversal of deregulation.

As a legacy of the 1930s, many banking regulations and laws were implemented that restricted competition among banks and between banks and other financial institutions perhaps because of the mistaken belief that "excessive competition" was the cause of the widespread bank failures of the 1930s. For example, both entry restrictions, such as government control of chartering, and restrictions that do not deal with entry, such as consumer deposit rate ceilings, at least have the potential to reduce competition. Although these anticompetitive regulations do not deal directly with bank risk taking, a reduction in competition would lead to "above-normal" profit levels (i.e., above the level that would be earned under full competition). And above-normal profits, in turn, may reduce the rate of bank failures by acting as a cushion against a threatening drop in the demand for bank services or a sudden large increase in the cost of providing those services.

Currently, many restrictions on bank competition are breaking down. Deposit-rate ceilings essentially have been eliminated on all but business checking accounts. Geographic restrictions on bank expansion are diminishing through the liberalization of branching laws and through regional interstate agreements. Product-line distinctions between banks and nondepository financial firms also are blurring. Is banking becoming more competitive and thus less profitable, and will bank failures consequently mount as profits decline? Or will deregulation merely change the way banks compete rather than increase the overall degree of competition?

In this *Letter*, I argue that the answer to these questions depends in large part on whether bank entry is market-determined or restricted by regulation. In banking, regulatory impediments are the primary potentially significant barrier to entry — a barrier to entry being a cost borne by a firm seeking to enter an industry that is not borne by a firm already in the industry. Thus, this *Letter* focuses on how regulation may have affected entry into banking and neglects possible nonregulatory barriers. Data for the period 1921-1983 are analyzed to determine whether and how regulation has affected the rate of bank entry in the past.

Entry and competition

Entry plays a prominent role in the economic theory of competition. Unrestricted entry is a key economic force that ensures there are neither too few nor too many firms in a particular industry and that individual firms charge competitive prices and operate efficiently. Above-normal profits constitute a strong lure to entry in an industry with too few competitors. New firms will be attracted to such an industry until profits and prices are forced down to competitive levels. Similarly, below-normal profit levels will induce firms to leave an industry until profits and prices rise to competitive levels.

Entry and the threat of entry are also strong forces that tend to prevent private arrangements to restrict competition, such as cartels, from being successful or even from forming in the first place. Cartels will be successful only if they can limit competition among their members *and* also prevent potential new entrants from competing.

Just as private attempts to restrict competition and to raise profits (such as cartels) generally will be unsuccessful in restricting competition unless entry also is limited, so will government regulations. This is because competition can take place along so many dimensions that it is virtually impossible to regulate all forms of competition from new entrants. As George Stigler stressed in a now classic article written in 1968, "When a uniform price is imposed upon, or agreed to, by an industry, some or all of the other terms of sale are left unregulated." For example, competition through quality, advertising, convenience, and by providing under-

priced services along with the good whose price is regulated may all be effective forms of what has come to be known as "nonprice" competition.

Thus, even when direct price competition is prohibited by regulation, in the absence of entry regulations, new firms will be attracted to an industry with above-normal profits and will compete along nonprice dimensions. They will spend more to enhance the nonprice attributes of the regulated good until profits are forced down to competitive levels. With entry regulations though, this competitive pressure by new firms will not be present.

The government, unlike private groups, does have strong enforcement tools to prevent entry by new firms. For example, in banking, entry can be controlled through chartering and branching regulation. Until recently, the government effectively prohibited entry into the interstate trucking, airline, and long distance telephone industries. With entry strictly regulated, even without other forms of regulation, above-normal profits are the norm. Moreover, with strictly regulated entry, other forms of anticompetitive regulations, such as prohibitions on price cutting, generally will lead to even larger profits at the expense of the public.

In sum, the regulation of price has the potential to increase the profits of regulated firms to above-normal levels, but only if entry is also limited by regulation. Whether entry regulation has actually reduced the rate of entry and thus created above-normal profits in banking is an empirical question to which we now turn.

Effects of chartering

The United States has a "dual" federal-state banking system. Currently, persons wishing to start a bank can apply for a federal charter from the Comptroller of the Currency or a state charter from the appropriate state banking agency. However, to obtain federal deposit insurance, state banks must either receive approval directly from the Federal Deposit Insurance Corporation (FDIC) or become members of the Federal Reserve System. (Federally chartered banks are all members of the Federal Reserve System and all have federal deposit insurance.)

In general, competition among chartering agencies would seem to limit any single agency's power to restrict entry. This is because if one agency severely restricted entry, firms would seek charters from other agencies. Over time, an agency with an overly restrictive chartering policy should find itself with few firms to regulate.

Prior to the passage of the Banking Act of 1935, which set up a federally administered "needs" criteria for chartering federally insured banks, there was active competition between the states and the federal government for the chartering of banks. However, with the passage of the Act and the creation of the FDIC, the competition for the chartering of *insured* banks was probably reduced since the owners of state-chartered banks had to apply either to the FDIC or the Federal Reserve to obtain federal deposit insurance. In this way, the federal government can now control the number of (federally) insured banks even though the power to do so is diffused through three agencies.

Previous studies

A classic 1965 study by Sam Peltzman concluded that competition for chartering was reduced by the passage of the Banking Act of 1935. He found that the federal control of chartering reduced the rate of bank entry at least 50 percent, based on a comparison of the rate of entry before 1936 to the rate during the 1936-1962 period. Below, I take another look at these data and extend the analysis from 1962 through 1983, the last year for which complete data are currently available.

A further analysis

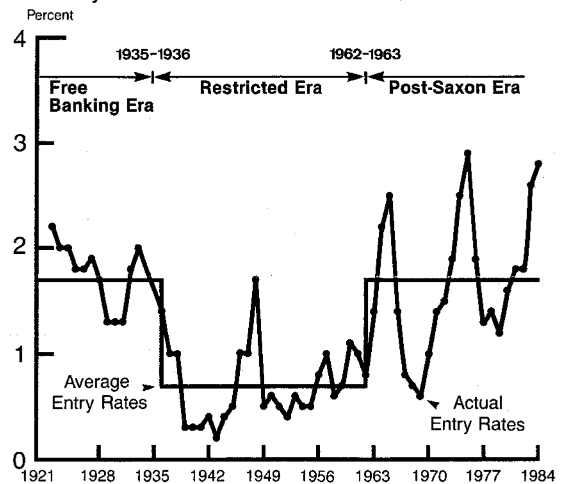
Although, according to Peltzman, the Banking Act of 1935 and the creation of the FDIC did substantially lessen state-federal competition for the chartering of insured banks between 1936 and 1962, there was still interagency competition between the FDIC, the Comptroller, and the Federal Reserve. More recently, as S&Ls have gained more and more bank-like powers (such as making commercial loans and offering checking accounts), the Federal Home Loan Bank Board, which controls the chartering of federally insured thrifts, may have increased the degree of competition among federal agencies for chartering. Because of this actual and potential competition among chartering agencies, it may well be that chartering would become a less and less *effective* restriction to entry over time. Thus, below, we look at entry rates during the post-1962 period in addition to those during the 1921-1962 period analyzed by Peltzman to

see if entry rates have remained low or whether they have increased.

Entry rates (the number of banks opening in a given year divided by the number of banks in existence at the end of the previous year) are plotted in the chart. For the period 1921-1935, the average rate of entry was about 1.7 percent per year. In contrast, during the 1936-1962 period, the average rate of entry declined to only .7 percent a year, a statistically significant decline of approximately the same magnitude found by Peltzman. Part of this decline was likely due to a reduction in the demand for charters, especially during the 1930s. However, the fact that entry rates remained low even after the Depression suggests that chartering also had changed. Thus, the evidence supports the notion that a change in chartering caused a significant decline in the rate of bank entry during the period following the passage of the Banking Act of 1935 up to 1962.

On November 15, 1961, James Saxon was appointed Comptroller of the Currency. He was widely regarded as a proponent of the national banking system and was viewed as being more liberal toward chartering than his predecessors. The data in the chart suggest that his policies initially raised these rates significantly. However, by the last year of his tenure (1966), entry rates had fallen back to the pre-Saxon level. One reason for this decline may be the credit "crunch" of 1966-1967. After the crunch, entry rates resumed their sharp upward rise and followed a cyclical pattern unique to the post-1962 period.

Looking at the 1963-1983 period as a whole, entry rates averaged essentially the same as during the 1921-1935 period. Thus, it appears that Saxon began an era in which entry into banking was no more difficult than during the relatively unrestricted period of chartering before the Banking Act of 1935. If correct, this means that banking has become a more competitive industry, at least since 1962. However, another interpretation of the data in the chart would be that entry restrictions were gradually relaxed beginning perhaps as early as 1950. In either event, currently, entry does not appear to be significantly restricted by regulation, at least in comparison to the pre-1930s era.



Conclusions

The recent deregulation of banking, in particular the removal of deposit-rate ceilings on almost all types of consumer accounts, appears to be taking place in an environment in which entry restrictions have been effectively eliminated or at least have been substantially relaxed. If so, recent consumer deposit rate deregulation should have little or no long-run effects on the profitability of the banking industry as a whole because the effectively unrestricted entry prior to this phase of deregulation would have ensured that bank profitability was at normal, competitive levels when the deregulation began.

However, individual banks may have had different experiences as they made the transition from nonprice to price competition. Further, if entry restrictions had been effectively removed prior to deposit rate deregulation, then deregulation, by eliminating the inefficiencies inherent in nonprice competition, should have led to an expansion of the banking industry relative to its nonbank competitors. This, in turn, would increase incentives for entry and may explain the very high entry rates of the last few years.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 8/7/85	Change from 7/31/85	Change from 8/8/84 Dollar	Change from 8/8/84 Percent[7]
Loans, Leases and Investments[1 2]	192,960	– 211	11,649	6.4
Loans and Leases[1 6]	174,464	– 286	12,059	7.4
Commercial and Industrial	51,203	– 227	1,244	2.4
Real estate	63,970	166	3,320	5.4
Loans to Individuals	35,179	70	6,170	21.2
Leases	5,396	– 1	355	7.0
U.S. Treasury and Agency Securities[2]	11,578	– 12	– 304	– 2.5
Other Securities[2]	6,919	88	– 104	– 1.4
Total Deposits	198,603	– 521	10,162	5.3
Demand Deposits	47,382	– 970	3,814	8.7
Demand Deposits Adjusted[3]	31,637	1,074	2,346	8.0
Other Transaction Balances[4]	14,277	480	1,746	13.9
Total Non-Transaction Balances[6]	136,944	– 31	4,602	3.4
Money Market Deposit Accounts—Total	44,992	24	7,168	18.9
Time Deposits in Amounts of $100,000 or more	37,797	27	– 3,098	– 7.5
Other Liabilities for Borrowed Money[5]	20,774	– 1,576	1,861	9.8

Two Week Averages of Daily Figures	Period ended 7/29/85	Period ended 7/15/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	67	55
Borrowings	19	106
Net free reserves (+)/Net borrowed(–)	47	– 51

[1] Includes loss reserves, unearned income, excludes interbank loans
[2] Excludes trading account securities
[3] Excludes U.S. government and depository institution deposits and cash items
[4] ATS, NOW, Super NOW and savings accounts with telephone transfers
[5] Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
[6] Includes items not shown separately
[7] Annualized percent change