Do Intermediation Returns and Concentration Increase Banking Stability?

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Abstract

This work presents a general setting to analyze the linkages between entry, concentration and regulation of the banking sector when banks are heterogeneous. Agents decide endogenously whenever to run a bank, i.e. entry, or to be a depositor. I show that when the intermediation return is high the economy reaches an inefficient equilibrium having agents with lower probability of project success running a bank. In an unregulated environment, this equilibrium makes banks unsolvable due to the lack of capital. However, capital requirement may prevent such an equilibrium and ensure banks solvability. Finally, the level of capital has to increase as bank margins and banking concentration raise. These results substantially contrast with respect to the previous literature on this topic.

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