

Banking Consolidation and Its Impact on Entrepreneurship: A Call to Support Small Businesses

Brett Bantle, Parker Jabas, and Oudom Hean, Ph.D.

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Introduction

Entrepreneurs and small businesses are pivotal to our economy and enhance our daily lives. Whether it's your favorite local restaurant or the trusted neighborhood auto repair shop, entrepreneurs enrich our communities and daily experiences. Yet, as the banking industry consolidates, entrepreneurs face mounting challenges. With banks merging into larger institutions, the options for loans and financial services are diminishing. This consolidation and dearth of new banks is transforming the financial landscape and raises questions about its impact on entrepreneurship. Will entrepreneurs and small businesses be able to access the capital required to start or grow their ventures given these trends in banking consolidation?

Recent research by Hean and Jabas (forthcoming) sheds light on the dynamic relationship between banking consolidation and entrepreneurship. As market competition, technological advancements, and regulatory changes drive the rapid consolidation of the banking industry, small businesses and entrepreneurs, who often rely on community banks, may face new challenges securing financing. Small businesses and aspiring entrepreneurs often

encounter hesitancy from larger banks when seeking loans, primarily due to their limited credit histories and relatively small-scale operations, which are perceived as higher-risk investments. As a result, it becomes increasingly difficult for entrepreneurs and small businesses to gain access to the resources they need to innovate and provide value to our communities.

So, what are the implications for entrepreneurs, small businesses, and the broader economy? How can policymakers address the challenges posed by banking consolidation? Understanding these dynamics is critical, as the rapid consolidation of the banking sector may have vast implications for the broader economy. Through this understanding, we aim to empower individuals, businesses, and policymakers to make decisions that can lead to increased economic flourishing for all.

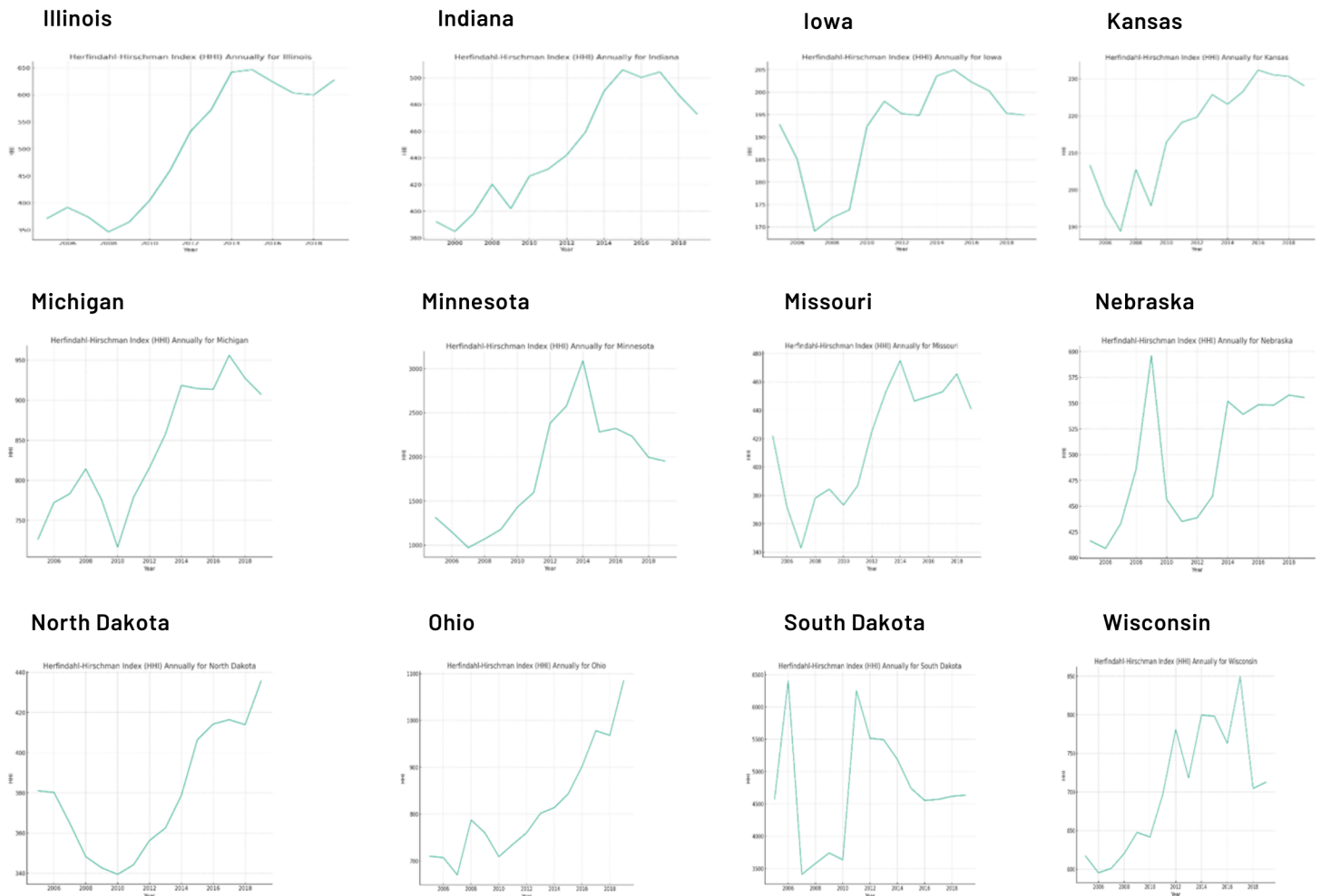
Findings

Hean and Jabas (forthcoming) focus on the U.S. Midwest, a region characterized by its economic, geographic, and demographic uniformity, which allows them to examine the impacts of banking consolidation with greater clarity. They study the period from 2005 to 2019, excluding the years affected

by the COVID-19 pandemic to ensure their analysis isn't distorted by unique circumstances.

They measure entrepreneurship using various business application metrics: total business applications, high-propensity business applications (those with a high likelihood of evolving into businesses with payrolls), applications from corporations, and applications with planned wages. To assess the banking sector's consolidation, they use the Herfindahl–Hirschman Index (HHI), a widely recognized measure of banking concentration. The HHI index spans from 0 to 10,000, where higher values signify increased market concentration and a smaller number of competing banks. Figure 1 highlights the increasing trend for HHI across states from 2006-2019.

Figure 1 Herfindahl-Hirschman Index by State



Source: Hean and Jabas (forthcoming.)

Notes: The HHI indices are based on the deposits held at various institutions. The data is provided by the Federal Deposit Insurance Corporation (2023.)

Their findings reveal a consistent trend: as banking consolidation intensifies, entrepreneurship declines across all application categories. Banking consolidation has a particularly negative impact on applications from corporations and applications with planned wages. These results underscore the detrimental effects of reduced banking competition on small business formation, job creation, and economic growth.

Implications

The implications of this research are not confined to the world of finance or abstract economic theory; they have direct consequences for individuals and communities. Understanding these implications is crucial for addressing the challenges posed by banking consolidation (and lack of new bank startups) and fostering a supportive environment for entrepreneurship.

1. Small Business Owners & Entrepreneurs

Small business owners and entrepreneurs are at the forefront of the implications of banking consolidation. For them, the research findings serve as a reminder of the challenges they face in accessing capital and financial services. As banks merge and become larger financial institutions and fewer new banks are formed, the lending landscape can become less tailored to the specific needs of small businesses. The research highlights the significance of community banks in facilitating entrepreneurship. Entrepreneurs who rely

on community banks often benefit from personalized services, local market knowledge, and a higher likelihood of securing financing. Recognizing the value of community banks, small business owners may consider building and maintaining relationships with these institutions to support their entrepreneurial endeavors. Moreover, entrepreneurs should be aware of the potential challenges posed by banking consolidation, and due to the trend presented, they may turn to alternative financing sources for their capital needs.

2. Consumers

Consumers also feel the effects of banking consolidation on entrepreneurship. With fewer small businesses in the market, consumers have fewer choices for goods and services. The research findings emphasize the importance of small businesses in providing diverse and innovative products and services to meet consumer needs. As small businesses decline, consumers may experience higher prices, reduced product diversity, and fewer opportunities to support local businesses. It becomes essential for consumers to actively seek out and support small businesses, contributing to the resilience of local economies.

Additionally, consumers should be aware of the potential consequences of banking consolidation on their personal finances. Reduced competition among banks can lead to higher interest rates on loans and mortgages, making it more expensive for individuals to purchase homes or finance

major life events. Understanding the financial landscape and exploring different banking and financing options can help consumers make informed decisions.

3. Policymakers and Regulators

Policymakers and regulators have a significant role to play in addressing the challenges posed by banking consolidation. They need to be aware of the potential negative impacts on entrepreneurship and small businesses of policies that unintentionally cause bank consolidation and discourage new bank formation. For example, a [Wharton study](#) found that increasing regulatory thresholds for larger banks in the Dodd-Frank Act incentivized banks to engage in bank acquisition. Moreover, a [recent speech](#) by a member of the Federal Reserve Board of Governors highlights the regulatory barriers to new bank formation. Before making any changes in regulation in reaction to recent bank failures, policymakers should be cognizant of these types of barriers.

Another approach policymakers can consider is creating incentives for larger banks to allocate a portion of their lending portfolio to small businesses. This can be achieved through tax incentives, preferential lending rates, or regulatory measures that encourage banks to engage with the small business community.

Moreover, regulators should pay close attention to the competitive landscape of the banking industry. Assessing and regulating

mergers and acquisitions to ensure that they do not excessively concentrate market power can help maintain a diverse and competitive banking sector.

Conclusion

The rapid consolidation of banking institutions in the United States has raised concerns about the accessibility of capital and financial services for entrepreneurs and small businesses. With fewer banking options and larger, centralized institutions, startups and small businesses face challenges in securing financing. The consistent trend we observe is that as banking consolidation intensifies, entrepreneurship declines across all application categories. This underscores the substantial impact of banking consolidations on individual entrepreneurs and businesses.

These findings carry significant policy implications, highlighting the need for regulators and policymakers to consider the consequences of any regulations or policy on bank consolidation. Individual entrepreneurs and small businesses, vital drivers of economic growth and job creation, are significantly affected. Encouraging reduction toward barriers to entry for new banks and reducing regulation-induced incentives to consolidate could enable continued access to small banks for entrepreneurs and small businesses.

Nevertheless, many unanswered questions remain regarding the mechanisms through which reduced banking competition affects entrepreneurship. Future research should

dive deeper into these mechanisms, particularly focusing on lending to small businesses and the challenges posed by office closures in remote areas. Exploring the impact on specific industries and the role of alternative financing services like peer-to-peer lending and crowdfunding would provide valuable insights.

This commitment to understanding, acknowledging, and facilitating an environment that enables entrepreneurship in the wake of banking consolidations is not just a theoretical exercise; it is a pragmatic approach to fortifying the foundation of the nation's economic future. It is a call for proactive measures that transcend mere observation, beckoning a collective responsibility to safeguard and nurture the spirit of entrepreneurship, ensuring it thrives despite the winds of economic change. In essence, this is a rallying cry for a paradigm shift—one where the unintentional consequences of policies that may hasten banking consolidations or limit new bank entry are considered and addressed. It is an assertion that in the face of economic shifts, we possess the agency to sculpt a future where entrepreneurship stands resilient, a force that propels economic growth, fosters innovation, and sustains the vitality of the United States' economic landscape.

Reference:

This research insight is based on a forthcoming paper titled, "Bank Competition and Business Formation in the U.S. Midwest" by Oudom Hean and Parker Jabas.

Hean, O., & Jabas, P. (forthcoming). Bank competition and business formation in the U.S. Midwest. *Journal of Financial Economic Policy*. DOI: 10.1108/JFEP-08-2023-0218

About the Authors



Brett Bantle, is a graduate student in the College of Business at North Dakota State University pursuing his MBA.

brett.bantle@ndsu.edu



Parker Jabas, is a graduate research assistant in the College of Business at North Dakota State University pursuing his MBA.

parker.jabas@ndsu.edu



Oudom Hean, Ph.D., is a scholar at the Challey Institute for Global Innovation and Growth and an assistant professor of finance North Dakota State University.

oudom.hean@ndsu.edu