

The Proconsumer Argument for Interstate Branching

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Interstate banking in the United States, an impossibility for many years, became a reality in the 1980s with the passage of state laws authorizing bank holding companies to expand across state lines. All but two states now allow an out-of-state holding company to acquire an in-state bank, and most large banking organi-

zations now have subsidiaries in several states. However, a significant barrier to interstate expansion still exists. It is not yet permissible for individual banks to establish branch networks that cross state boundaries. Interstate expansion is possible only at the holding company level.

This remaining obstacle to interstate banking is critical because it can raise banks' costs of expanding interstate and also limit the potential benefits to consumers. Maintaining an independent, out-of-state subsidiary can be more costly for an institution than operating a

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cross-state branch network.¹ And branch networks provide particular convenience benefits to consumers. Most important, while consumers can deposit funds into their accounts at any branch of their bank, they cannot make deposits via an out-of-state affiliate of their bank.

Removal of the legal impediments to interstate branching surely would lead to the creation of interstate branch networks, in part because some bank holding companies currently operating interstate would choose to merge subsidiary banks. This geographic expansion would benefit consumers of banking services. Consumers in multistate areas would gain easier access to their bank accounts and related services. In addition, interstate branching would be procompetitive. For instance, blanket repeal of federal interstate branching restrictions would enable national banks to enter out-of-state markets by establishing new branches there.² Such *de novo* entry (as opposed to entry via acquisition) would tend to make a market more competitive, especially in the case of markets that, prior to entry, had been dominated by a small number of institutions. As a result, consumers in these markets would likely be offered more favorable rates and fees.³

¹ For elaboration on this point, see Mengle (1990) and Svare (1992).

² Whether restrictions on interstate branching by national banks will be repealed without conditions remains to be seen. Some proposals would repeal existing federal restrictions but allow individual states to pass laws that restrict interstate branching. Given such authority, some states might opt to forbid the establishment of *de novo* interstate branches. See Mengle (1990) for discussion of alternative proposals.

³ The relationship between structure, conduct, and performance in banking markets has been studied extensively. There is general agreement that markets dominated by a few institutions tend to be less competitive, with banks in those markets offering lower deposit rates and having higher fees and loan rates. See, for example, Calem and Carlino (1991) and Hannan (1991).

Despite these potential benefits to consumers, interstate branching proposals have generally been opposed by consumer advocates.⁴ In part, this opposition has arisen because the benefits have not been thoroughly articulated. More important, opponents of interstate branching fear that it would lead to domination of local markets by large multistate banks. They are concerned that these institutions would be less willing to lend to small local businesses and would be less responsive to community needs in general.

This article examines the various pros and cons of geographic deregulation, focusing on the potential impact of interstate branching on consumer convenience, competition, and credit availability. There are, of course, other matters relevant to interstate branching. For example, by lowering the costs of geographic expansion, interstate branching may enable banks to reduce the riskiness of their loan portfolios through further geographic diversification.⁵ My intention, however, is to examine only those issues that directly affect retail and small-business customers. Indeed, recent debate over interstate branching has emphasized such consumer issues.⁶

THE CURRENT STATUS OF INTERSTATE BANKING

Banking deregulation during the 1980s loosened the constraints on interstate banking considerably. Unlike other major regulatory initia-

⁴ See, for example, the statements by representatives of the Consumers Union, the Consumer Federation of America, and the U.S. Public Interest Research Group before the Subcommittee on Consumer Affairs and Coinage, U.S. House of Representatives (U.S. Congress 1991).

⁵ For discussion of this issue and other considerations related to interstate branching, see Mengle (1990) and U.S. Congress (1991).

⁶ See U.S. Congress (1991).

tives during this period, such as the lifting of ceilings on deposit interest rates, interstate banking reform occurred at the state rather than the federal level. Since 1956, the Douglas Amendment to the federal Bank Holding Company Act has prohibited interstate acquisitions by bank holding companies, except where authorized by the acquired bank's home state. During the 1980s, most states changed their laws to permit entry by out-of-state bank holding companies.

Only two states, Hawaii and Montana, have yet to adopt a law allowing entry by an out-of-state holding company.⁷ Thirty-five states now permit entry on a nationwide basis, with the stipulation (in most cases) that the entering bank's home state have a reciprocal law. Fourteen states (plus the District of Columbia) allow entry on a regional reciprocal basis.⁸

One significant limitation of these interstate banking laws is that most states do not allow out-of-state holding companies to establish de novo bank subsidiaries in the state. Rather, entry by out-of-state banking organizations is restricted to acquisitions of existing banks. Only 19 states allow de novo entry.⁹

Geographic deregulation during the 1980s

resulted in numerous interstate mergers and acquisitions, transforming the structure of the banking industry. One dramatic consequence of this merger activity has been the creation of so-called "superregionals." Huge multistate organizations emerged from consolidations involving two or more large banks, as in the case of NationsBank Corporation in the South, or through the acquisition of many smaller banks by a major institution, as in the case of Banc One Corporation in the North Central region.

A list of the 25 largest banking organizations in the U.S. and the states in which they operate bank subsidiaries (Table 1) shows that almost all large banking organizations now have subsidiaries in several states.

Many smaller organizations also have expanded interstate. For example, 14 bank holding companies headquartered in Pennsylvania or New Jersey operate out-of-state bank subsidiaries. These institutions (Table 2) range in size from \$240 million to \$52 billion in assets; seven of them have less than \$2 billion in assets.

Restrictions on Interstate Branching. While bank holding companies can now cross state lines, various legal obstacles preclude interstate branching by commercial banks.¹⁰ Foremost among these is the McFadden Act, a federal law dating from 1927 that rules out interstate branching by national banks.¹¹ The

⁷ Hawaii permits entry by institutions from Guam, American Samoa, and several other Pacific territories, subject to reciprocity.

⁸ The District of Columbia also allows entry on a nationwide basis for institutions outside the D.C. region that meet certain community reinvestment and job creation requirements. For details on each of the state laws, see "State Laws Gain Renewed Significance as Congress Stumbles," Banking Policy Report, January 6, 1992, pp. 10-14, and "A Look at Laws Granting Interstate Powers to Banks," *American Banker*, March 20, 1992, p. 8.

⁹ The states allowing de novo entry are Arizona, Colorado (effective July 1, 1993), Connecticut, Maine, Maryland, Massachusetts, Michigan, Minnesota, Nevada, New Hampshire, New Jersey, New Mexico, New York, Ohio, Pennsylvania, Rhode Island, South Dakota, Texas, and Vermont.

¹⁰ Federally chartered thrifts, on the other hand, are no longer subject to such a restriction. The Office of Thrift Supervision, in April 1992, adopted a rule allowing full nationwide branching for healthy federally chartered savings and loan institutions.

¹¹ For an overview of the history of branch banking in the U.S., including further discussion of the McFadden Act, see Mengle (1990). A loophole in the act allows a national bank to relocate its headquarters up to 30 miles, even across a state line. U.S. Bancorp recently exploited this loophole to branch from Oregon into Idaho. See "Fed Gives Interstate Issue a Push by Easing Bank Relocation Rule," *American Banker*, February 27, 1992, p. 1.

TABLE 1
25 Largest Banking Organizations and States
in Which They Operate Bank Subsidiaries
 (as of 12/31/92)

Name of Institution	Total Assets (millions \$)	Region ^a
1 Citicorp	213,701.0	AZ, CA, CO, DE, FL, MD, ME, NV, NY, SD
2 BankAmerica Corp.	180,814.0	AZ, CA, ID, NV, OR, TX, WA
3 Chemical Banking Corp.	134,655.0	DE, NJ, NY, TX
4 NationsBank Corp.	119,805.0	DC, FL, KY, MD, NC, SC, TN, TX, VA
5 J.P. Morgan & Co., Inc.	102,941.2	DE, NY
6 Chase Manhattan	95,862.3	AZ, CT, DE, FL, MD, NY
7 Bankers Trust New York Corp.	72,448.0	DE, FL, NY
8 Banc One Corp.	61,331.6	IL, IN, KY, MI, OH, TX, WI
9 Wells Fargo & Co., Inc.	52,536.9	CA
10 PNC Financial Corp.	51,523.0	DE, KY, NJ, OH, PA
11 First Union Corp.	51,326.6	FL, GA, NC, SC, TN
12 First Interstate Bancorp, Inc.	50,863.1	AK, AZ, CA, CO, ID, MT, NV, NM, OR, TX, UT, WA, WY
13 First Chicago Corp.	49,281.0	DE, IL, WI
14 Fleet Financial Group, Inc.	47,121.5	CT, MA, ME, NH, NY, RI
15 Norwest Corp.	44,557.1	CO, IA, MN, MT, ND, NE, SD, WI, WY
16 Bank of New York Co., Inc.	41,023.0	DE, NY
17 NBD Bancorp, Inc.	40,843.2	FL, IL, IN, MI, OH
18 Barnett Banks, Inc.	39,631.0	FL, GA
19 SunTrust Banks, Inc.	36,647.2	FL, GA, TN
20 Wachovia Corp.	33,356.1	DE, GA, NC, SC
21 Bank of Boston Corp.	32,346.1	CT, FL, ME, MA, RI
22 Mellon Bank Corp.	31,540.7	DE, MD, PA
23 First Fidelity Bancorporation	31,481.6	NJ, NY, PA
24 National City Corp.	28,963.5	FL, IN, KY, OH
25 Comerica, Inc.	26,660.0	CA, MI, OH, TX

^aExcept in the case of PNC Financial and Mellon, the Delaware subsidiaries of institutions listed in the table are limited-purpose banks.

TABLE 2
Banking Organizations Headquartered in NJ or PA That
Have Out-of-State Bank Subsidiaries^a
 (as of 12/31/92)

Name of Institution	Total Assets (millions \$)	Locations of Subsidiaries
PNC Financial	51,523.0	DE, KY, MA*, NJ, OH, PA
Mellon Bank Corp.	31,540.7	DE, MA*, MD, PA
First Fidelity Bancorporation	31,481.6	CT*, NJ, NY, PA
CoreStates Financial Corp.	23,774.4	NJ, PA
Midlantic Corp.	14,423.1	NJ, NY, PA
UJB Financial Corp.	13,794.6	NJ, PA
Meridian Bancorp, Inc.	12,221.1	DE, NJ*, PA
Susquehanna Bancshares	1,727.9	MD, PA
F.N.B. Corporation, Inc.	1,698.6	OH, PA
Commerce Bancorp, Inc.	1,428.0	NJ, PA
B.M.J. Financial Corp.	655.1	NJ, PA
State Bancshares	557.4	NJ, PA
Vista Bancorp	336.9	NJ, PA
Glendale Bancorporation	236.7	NJ, PA

^a Limited-purpose banking subsidiaries are not considered.

*As of this writing, this institution has signed a deal to acquire a bank in this state. Total assets reported in the table do not reflect this proposed transaction.

Federal Reserve Act applies this constraint to state-chartered banks that are members of the Federal Reserve System. Moreover, all but five states generally prohibit the operation of in-state branches by out-of-state banks.¹²

Proposals to permit nationwide interstate branching were considered by Congress during 1991. These measures were included as part of comprehensive proposals to restructure regulation of the banking industry. For instance, the

Treasury Department submitted a banking reform bill that would have authorized interstate

¹² According to the Conference of State Bank Supervisors, out-of-state banks are allowed to establish branches in Alaska, Massachusetts, Nevada, New York, and Rhode Island (but in Massachusetts and Rhode Island, only entry via branch acquisition is permissible). These laws, in effect, authorize entry by state-chartered banks that are not members of the Federal Reserve System. In addition, "Florida

branching by national banks. In addition, the bill would have allowed banking organizations to engage in a broader range of financial activities, and it would have permitted nonfinancial firms to own banks within a "diversified holding company" structure. But comprehensive restructuring was put on hold. Instead, Congress decided to grapple with the more pressing issues of deposit insurance reform and recapitalization of the FDIC's bank insurance fund.

In 1992, Treasury tried to rally support for a narrower bill that would have permitted nationwide branching and limited insurance activities. Because of disagreements among bankers and between the banking and insurance industries over the specifics of such a bill, no bill was introduced. Nevertheless, interstate branching remains a key topic on the banking reform agenda, one which Congress is likely to revisit in the future.

INTERSTATE BRANCHING AND CUSTOMER CONVENIENCE

One need not be an economist to surmise that branch networks provide convenience in

allows an outsider to branch into the state via merger or acquisition if its home state has a reciprocal law" (*American Banker*, December 16, 1992, p. 2.)

I am aware of at least one instance in which a state regulatory agency approved an interstate branch acquisition in a state where such transactions are permitted only under exceptional circumstances. This was the case in Pennsylvania in February 1992, when the state Department of Banking and the FDIC allowed Wilmington Trust Company, a Delaware Bank, to merge with a failed Pennsylvania bank and operate its sole office as a branch. The department has not yet ruled on whether current state law would allow Wilmington Trust to establish additional branches in Pennsylvania now that it has obtained a foothold.

There are a few interstate bank branches around the country that were established before either state or federal laws forbade them and that have been "grandfathered," i.e., permitted to remain in operation. For instance, Midlantic Bank, a New Jersey bank, operates a "grandfathered" branch in downtown Philadelphia.

the form of greater access to accounts and related services across the geographic area covered by the network. Clearly, then, interstate branching would enhance the convenience of bank customers who frequently cross state lines. In addition, interstate branching would benefit businesses that require banking services at diverse locations in more than one state. A further potential convenience benefit is somewhat more subtle. Economic reasoning and empirical evidence indicate that interstate branching will tend to have a favorable impact on branch coverage, i.e., on the total number of bank branches serving a given area.

Enhanced Convenience for Consumers in Multistate Areas. Anyone who frequently crosses a state line, for work, for shopping, for business or pleasure, stands to benefit from interstate branching. Interstate branching would provide these customers with convenient access to their accounts and related banking services.

Current restrictions on interstate branching adversely affect such customers in two ways. First, these restrictions may keep some banking institutions from expanding interstate, since expansion at the holding company level can be more costly. Second, interstate banking at the holding company level cannot provide the same level of convenience as interstate branching. In particular, a consumer cannot deposit funds into his or her account through an out-of-state affiliate of his or her bank, and certain account-specific services such as check-cashing may not be obtainable at branches of an affiliate.¹³

Bank branching is important to customers for a number of reasons. First, small-business customers are very dependent on branch banking, both for teller transactions and for special

¹³ The McFadden Act (as it has been interpreted) also prevents a bank from accepting deposits through out-of-state ATMs. Thus, repeal of the act would enable consumers to deposit funds into their bank accounts at out-of-state locations through ATMs.

services such as night depository, account reconciliation, and financial counseling.¹⁴ Second, despite teller machine networks, the typical retail customer regularly visits a brick-and-mortar branch to conduct transactions.¹⁵ Third, consumers may save on transactions fees by using automated teller machines located at branches of their banks, since banks usually charge higher fees for transactions at ATMs that are “nonproprietary” (owned by other banks).¹⁶

The number of people in the U.S. living and working in multistate areas who are apt to benefit from interstate branching is substantial. Six consolidated metropolitan statistical areas (CMSAs) and an additional 28 metropolitan statistical areas (MSAs) cross state boundaries,

and approximately 66 million people reside in these multistate metropolitan areas, according to the 1990 U.S. Census.¹⁷

In addition to benefiting bank customers in localities that straddle state boundaries, interstate branching would be advantageous to customers who require banking services at diverse locations in two or more states, primarily businesses with multistate operations. Under current branching restrictions, such a customer may be pressed to maintain relationships with multiple banks. For instance, a business may have to maintain checking accounts at several banks, which may complicate the firm’s cash management and increase its fee expenses.¹⁸

Increased Branch Coverage. The value to a bank of adding a branch at a particular location depends on the branch’s potential to attract new depositors and borrowers and its potential convenience benefits to current customers. Legal restrictions on branching may prevent some banks from realizing their full branching potential. Locations where these banks would have established branches will be left unserved, unless other banks are willing and able to locate there, which will not always be the case.¹⁹ Under current restrictions on interstate branching, an out-of-state bank holding company can create a new bank subsidiary to operate a branch. But creating a new bank subsidiary can be more costly and of less convenience value

¹⁴ According to a 1989 survey, more than 20 percent of small-business owners or officers visit their branch daily on behalf of the company. Forty percent are in the branch once a week or more; 88 percent report that branch employees know them by name; only 3 percent never visit a branch. Other small-business employees also make frequent branch visits on behalf of their company. See Trans Data Corporation (1989a).

¹⁵ According to a 1989 survey, 95 percent of consumers visit a branch at least once each month to conduct transactions. Per household, the average number of trips to a branch is about three per month; branch visits are more frequent among higher income households. Close to half of the respondents (47 percent) reported that they do not use teller machines, and of these households, almost 60 percent indicated that “nothing could get them to use an ATM.” See Trans Data Corporation (1989b).

¹⁶ According to a 1988 survey, less than 20 percent of ATM-offering banks and thrifts (having more than \$750 million in deposits) charged “us-on-us” transaction fees, and only 1 percent planned to add such fees in 1989. However, over 60 percent of such institutions charged for “us-on-others” transactions, and 12 percent more planned to begin charging such fees in 1989. The mean “us-on-us” transaction fee for institutions charging such fees was 21 cents, while the mean “us-on-other” fee for institutions charging such fees was 70 cents. See Trans Data Corporation (1988).

¹⁷ Consolidated metropolitan statistical areas and metropolitan statistical areas are constructs defined by the U.S. Office of Management and Budget.

¹⁸ According to Nakamura (1993), “in general, large firms have multiple relationships with banks. [Surveys of large corporations] show how complex these relationships can be.” In part, these multiple banking relationships are a consequence of restrictions on bank branching.

¹⁹ Other banks may not attach as much value to the additional branch or may have to incur higher costs to operate the branch.

than adding a branch to an existing network.

Thus, branching restrictions tend to reduce total branch coverage. By this reasoning, we can expect that repeal of interstate branching restrictions would have a beneficial impact on branch coverage because banks would establish branches at previously unserved locations as they expand interstate.

Empirical support for this line of reasoning is found in studies that investigate the factors determining bank branch coverage. Evanoff (1988) analyzes 1985 data on branch coverage for each county in the 48 contiguous states. He finds fewer branches per square mile in states with legal restrictions on branching, holding constant other factors such as whether the county is rural or urban. Similarly, Calem and Nakamura (1993), using 1990 data and controlling for a wide range of factors, find reduced branch coverage in states with highly restrictive branching laws. They find that, on average, branching restrictions entailed one less branch in non-MSA counties and 13 fewer branches in urban counties, holding county population, population density, and other factors constant.²⁰

INTERSTATE BRANCHING AND COMPETITION

Some opponents of interstate branching have argued that branching restrictions are procompetitive, as they prevent large banks from acquiring smaller banks and turning them into branches. Thus, these restrictions help keep banking markets from becoming too concentrated.²¹ This argument is less than convinc-

ing, for two reasons. First, many of the mergers or acquisitions that would take place under interstate branching would occur in unconcentrated markets or would be between banks operating in distinct markets or between banks that are subsidiaries of the same holding company. In general, such consolidations would not substantially raise concentration in banking markets. Second, federal bank regulators and the U.S. Department of Justice have the authority to block any acquisition or merger deemed to have anticompetitive effects. Hence, branching restrictions are not needed to prevent excessive market concentration.²²

On the contrary, economic reasoning suggests that the lifting of interstate branching restrictions would benefit consumers by furthering competition in banking markets. The potential for banks to expand their branch networks across state lines could enhance competition in several ways. First, banks would be able to engage in nonprice competition more efficiently; some banks would be freed from having to provide convenience in forms that are more costly and less satisfactory than branching. The cost-savings would be passed on to consumers through lower prices. Second, for reasons discussed below, a bank establishing an extensive, multimarket branch network might opt to institute uniform pricing (uniform fees and interest rates) across disparate local markets by aligning prices in concentrated markets with those in competitive locales. Thus, branching tends to reduce price differentials between concentrated and competitive mar-

²⁰ Non-MSA counties in states without restrictive branching laws had a mean of 9 branches, while MSA counties in those states had a mean of 58 branches.

²¹ Market concentration refers to the number and size distribution of firms in a market. More concentrated banking markets tend to be less competitive (see footnote 3).

²² Under the Bank Merger Act and the Bank Holding Company Act, federal bank regulators must analyze the competitive effects of proposed mergers and acquisitions of banks and bank holding companies. If a proposed merger is expected to have a substantially adverse effect on competition, the merger application would be denied. In addition, the Justice Department has the authority under antitrust statutes to block anticompetitive mergers or acquisitions.

kets. Third, in many instances banks will choose to branch interstate by establishing *de novo* branches, thereby reducing concentration in the targeted markets. Let us elaborate on each of these arguments in turn.

Branching and Nonprice Competition. In markets where branching restrictions impose inconveniences on bank customers, banks may be compelled, through competition, to partly “compensate” their customers for these inconveniences. Such nonprice competition could take the form of longer banking hours, more tellers per branch, or other amenities that would mitigate the loss of convenience due to limited branching.

Providing such services drives up bank costs and results in higher fees and lower deposit interest rates for bank customers. Nevertheless, many bank customers will prefer some such nonprice “compensation” for lack of branching, even if they have to pay for it with higher fees. Banks would compete for these customers by providing them with the various amenities.²³

In this sense, interstate branching restrictions may engender inefficiency in the provision of banking services, at least in markets that straddle state boundaries. Such restrictions may force banks to substitute less suitable and more expensive forms of convenience for their customers, who, in turn, would have to pay higher fees or accept lower deposit interest rates. With the lifting of such restrictions, nonprice competition would become more efficient. Through interstate branching, banks would be able to provide their customers with

greater accessibility and convenience, at a lower cost.²⁴

Branching and Intermarket Price Differentials. For several reasons, a bank having an extensive, multimarket branch network might opt to institute uniform pricing across disparate local markets by aligning prices in concentrated markets with those in competitive locales. One important motive for a bank to centralize pricing decisions is to economize on managerial or coordination costs. Uniform pricing may also enable the bank to save on advertising costs. In addition, the bank may want to institute uniform pricing across a multimarket area as a benefit to customers who reside in the area’s largest banking market (the regional economic center), many of whom may regularly visit and conduct transactions at other localities in the area. A bank may be motivated to do so if the regional economic center is also the area’s most competitive banking market.²⁵

To the degree that branching motivates uniform pricing across multimarket areas, it tends to reduce price disparities between concentrated and competitive markets. Thus, when banks can branch freely across local markets, deposit interest rates in concentrated markets tend to be higher, and fees and loan rates lower, than they would be in the absence of branching. Through branching, competition is “exported” to concentrated markets. In this way, allowing banks to branch interstate would be procompetitive.

The preceding argument establishes in theory that bank branching furthers competition. But is this effect of branching on competition sig-

²³ Of course, there may be some customers for whom limited branching imposes minimal inconvenience. These customers would not require compensation for lost convenience. A bank may choose to specialize in serving these customers by defining itself as a “no-frills” bank, offering lower fees and/or higher rates but few amenities.

²⁴ I am grateful to Sherrill Shaffer for suggesting the idea that branching restrictions may cause inefficient nonprice competition.

²⁵ For a formalization of this argument, see Calem and Nakamura (1993).

nificant in practice? Empirical evidence indicates that it is. In particular, comparison of unit banking states to branching states with respect to within-state, cross-market differences in bank deposit interest rates indicates larger differentials in unit banking states. This is precisely what one would expect to find if branching is accompanied by consistency in pricing across local markets.

Table 3 reports statistics pertaining to within-state, cross-market differences in money market deposit account interest rates. The statistics are based on Federal Reserve survey data from 1985.²⁶ We compute the mean and standard error of these interest rate differentials for randomly selected pairs of banks from states that, in 1985, had severe restrictions on branching (pairs from "unit banking states"), and we do likewise for all other pairs (drawn from "branching states").²⁷ Paired banks are drawn from distinct markets within the same state. As indicated in the table, cross-market interest rate differentials are larger in unit banking

states.²⁸ This finding is consistent with the view that branching reduces price disparities across local markets.²⁹

Additional evidence is found in Mester (1987). Mester's study examines how competition among S&Ls varies across local markets in California. The study presents evidence that competition is "exported" to concentrated markets where rival S&L branch networks meet. Specifically, S&L deposit interest rates are found to be lower in markets (counties or MSAs) that are highly concentrated, but this effect is less pronounced if the market contains local branches of statewide institutions.

Interstate Branching and De Novo Entry. Nationwide interstate branching would further stimulate competition to the extent that it promotes de novo entry. In contrast to entry

²⁸ The difference between the two means is statistically significant at the 1 percent level.

²⁹ Calem and Nakamura (1993) confirm this finding in the more rigorous context of a multivariate analysis and repeat the analysis using 1990 data, obtaining qualitatively the same result.

²⁶ Data are obtained from the Federal Reserve's 1985 Monthly Survey of Selected Deposits and Other Accounts. We report statistics based on bank MMDA rates averaged over August, September, and October.

²⁷ As recently as 1985, 13 states had severe restrictions on bank branching: Colorado, Illinois, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, North Dakota, Oklahoma, Texas, West Virginia, and Wyoming. In each of these states, more than 97 percent of statewide deposits were in banks with fewer than 10 branches. Since then, each of these states has eliminated or at least relaxed its in-state branching restrictions.

TABLE 3
MMDA Interest Rate Differentials
for Randomly Paired Banks
(Cross-Market Pairs)

	Unit Banking States	Branching States
Mean Rate Differential	.38	.22
No. of Pairs in Sample	48	114
Standard Error	.06	.02

via acquisition of an existing bank or branch, the establishment of a *de novo* bank or branch has an immediate, direct impact on market concentration, increasing the number of competitors.

Would the elimination of the legal constraints on interstate branching lead to substantial *de novo* entry into local banking markets? Very likely the answer is yes, assuming that these restrictions are lifted unconditionally or not in a way that would result in legal obstacles to *de novo* entry. *De novo* entry via branching can be less costly than entry at the holding company level via the creation of a new bank subsidiary, which, in turn, generally is less costly than the establishment of a new institution directly by investors. Hence, elimination of legal constraints on interstate branching would expand the number of potential *de novo* entrants into any given banking market.³⁰

Recent history provides evidence that easing of geographic constraints on banks is a stimulus to *de novo* entry. In a carefully executed, empirical study covering the period 1976-1988, Amel and Liang (1993) find a substantial, positive relationship between the number of *de novo* bank branches established in a state and the lifting of restrictions on in-state branching or on entry by out-of-state bank holding companies.³¹

IMPACT ON CREDIT ALLOCATION

Much of the controversy surrounding interstate branching concerns the impact it may

have on the allocation of credit. Opponents of interstate branching fear that large multistate institutions will be less oriented toward small businesses and will siphon funds away from local community needs. Therefore, to the extent that small independent banks are replaced by these large institutions, small businesses will suffer.

There may be some truth to the notion that smaller banks are more oriented toward small-business lending than larger organizations. To some degree, all banks function as "information specialists," uniquely suited to evaluate credit risks and monitor borrowers.³² Thus, banks in general lend to a more diverse group of borrowers than, for instance, the bond market. Naturally, however, there are differences among individual banks with respect to their informational roles. In general, small banks produce small-business loans more efficiently than large banks, while large banks have a comparative advantage at lending to medium-size or large borrowers.³³ Empirical evidence shows that small businesses depend more heavily on small or medium-size banks.³⁴

³² See Calem and Rizzo (1992) for discussion of (and empirical evidence on) the role of banks as information specialists.

³³ At large banking organizations the lending process tends to be more streamlined, with lenders relying more heavily on standardized underwriting formulas. This favors large and medium-size firms, which are better able to supply information in a standardized form.

In a large multistate banking organization, local branch personnel typically have little discretion in their decision-making, while nonlocal personnel who are less constrained may be less well informed about or less sensitive to the needs of the local economy. Community banks, on the other hand, tend to be more flexible, better able to acquire and respond to specialized information about small local borrowers.

³⁴ For example, according to Danielson (1992), Barnett Banks (a Florida-based superregional) "claims relationships with 42 percent of Florida companies with annual

³⁰ Similarly, repeal of the Douglas Amendment, to allow a bank holding company to establish a *de novo* subsidiary in any state, would eliminate an additional, important barrier to entry.

³¹ Amel and Liang also find that *de novo* bank entry into local markets declined subsequent to relaxation of state-wide branching restrictions, presumably because branch entry is a less costly substitute for bank entry. However, bank entry did not decline in this case as much as branch entry increased.

But are small institutions in danger of disappearing from the banking scene? Large institutions may, indeed, enjoy a cost advantage relative to small, community banks, in part because lending to small business may be a more costly activity (involving higher expenses per dollar loaned). Also, many small banks may have to pay more for deposits because they do not offer the convenience of a branch network (although others may attract sufficient deposits by offering more personalized service as a substitute for convenience). Large banks also may enjoy economies of scale with respect to advertising and marketing activities. Nevertheless, small banks will continue to coexist with large institutions, even under interstate branching, as long as they have a critical role to play in small-business lending. That is, small banks would remain profitable because small businesses would be willing to pay for their services.

Thus, there is little reason to believe that interstate branching will bring about the demise of independent community banks. To the extent that these banks are particularly responsive to the needs of small businesses and local communities, there will be enduring demand for their services, and they will continue to occupy profitable niches.

Indeed, thus far, fears that unfettered geographic expansion by large banking organizations would lead to the demise of community banks have proven groundless. For example, banks in California have enjoyed unrestricted statewide branching since 1927, and the state has had a regional interstate banking law since 1987; five of the 25 largest banking organiza-

tions in the U.S. currently operate subsidiaries there. Nevertheless, California has 442 banking institutions having less than \$1 billion in assets, including 343 community banks with less than \$200 million in assets, and these banks appear reasonably profitable.³⁵ Another example is Florida, which has permitted statewide branching for most of the last two decades, and which has had a regional interstate banking law since 1984.³⁶ As reported by Danielson (1992), "four superregionals now control more than half of the state's deposit base. But these regional giants face stiff competition from more than 300 community banks." Community banks have also held their own vis-a-vis superregionals and other large banks in North Carolina, which, like Florida, has long had statewide branching and has had regional interstate banking since 1984. In North Carolina "roughly 90 banks with assets less than \$1 billion registered an average return on assets of 1.05 percent for the first three quarters of last year exactly the same as the nine banks with assets of \$1 billion or more."³⁷

Further, while smaller banks may be somewhat more oriented toward small-business lending than larger organizations, it is certainly not

³⁵ Only 18 banking organizations in the state have more than \$1 billion in assets. These numbers are as of December 31, 1992.

According to Zimmerman (1990), California's community banks earn returns on assets "roughly comparable to those of larger rivals." According to Zimmerman (1992), after 1990, as the recession took hold and earnings at California banks declined across all size categories, larger banks suffered the steepest declines.

³⁶ Until 1990, Florida permitted statewide branching only through merger.

³⁷ See Bill Atkinson, "Small Carolina Banks Thrive in a Land of Giants," *American Banker*, February 9, 1993, p. 6. Another state where community banks have held their own, despite statewide branching by large banks, is New York. See King (1985).

sales exceeding \$50 million, and with 30 percent of firms with sales from \$5 million to \$49 million annually. Its share with smaller companies, however, is only 12 percent, reflecting small bank strengths in this vital market."

Nakamura (1993) argues that smaller banks have a comparative advantage at lending to small borrowers. He summarizes existing empirical evidence and presents new evidence in support of this view.

the case that large banking organizations have no stake in lending to small businesses. In fact, according to Svare (1992), a number of large interstate banking institutions, such as Albany-based KeyCorp and Minneapolis-based Norwest, have strategically targeted consumers and small to midsize businesses. These institutions have sought to maintain flexibility and a local orientation through decentralized decision-making.

Large banks also engage in small-business lending as a way to meet their responsibilities under the federal Community Reinvestment Act (CRA). The CRA requires that every bank meet the credit needs of its entire community, to a degree consistent with safe and sound banking practices. Large banks' efforts to comply with the CRA generally include lending to small businesses and funding community development projects.³⁸ These efforts are likely to increase in the future because regulators are placing greater emphasis on banks' CRA obligations. If, however, multistate banks come to dominate some local market and act contrary to the interests of the local community, that case can be addressed through regulatory enforcement of the CRA.

While interstate branching may have the potential to harm local borrowers, it also has the potential to benefit them. In particular, a multistate bank may be in a better position to import funds into a community to finance a major local project. First, the geographically diversified bank can tap into its deposit base outside of the local community as an alternative to the national funds markets. Second, larger banks may have access to larger amounts of funds in the national markets, at lower cost, as compared with small, community banks, holding other factors (such as bank capital

ratios) constant.³⁹ Smaller banks may be perceived as greater credit risks by the funds markets because their asset portfolios tend to be less diversified and because they are less well known.⁴⁰

CONCLUSION

Removal of legal barriers to interstate branching would benefit consumers of banking services. Consumers in multistate areas would gain more convenient access to their accounts and related services. In addition, elimination of these barriers would enhance competition in banking, benefiting consumers through more favorable interest rates and fees. Also, interstate branching may facilitate the importation of funds into areas where credit demand is particularly strong.

Interstate branching raises some concerns regarding domination of local markets by large multistate banks that would be less oriented toward community credit needs. These concerns have been overstated, however. The evidence indicates that as long as there is sufficient demand for the credit services of community banks, there will be a profitable niche for these banks to occupy. And most large interstate organizations will seek to remain responsive to the needs of local customers.

As multistate organizations increase in number, size, and breadth, a few of them may become insensitive to community credit needs.

³⁹ For theory and evidence on the relationship between bank size and access to the federal funds market, see Allen and Saunders (1986) and Allen, Peristiani, and Saunders (1989).

⁴⁰ In addition, small-business borrowers, along with other small-bank customers, will obtain the convenience benefits described previously if small banks choose to branch interstate. It seems very likely that some small banks in multistate locales will establish out-of-state branches, just as some small holding companies have chosen to establish out-of-state subsidiaries (recall Table 2).

³⁸ For a detailed discussion of the CRA and related issues, see Calem (1989).

But through existing regulations governing community reinvestment, regulators have the ability to safeguard community interests. On

balance, available evidence indicates that the removal of interstate branching restrictions would be advantageous to consumers.

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