Research Department
Federal Reserve
Bank of
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FRBSF Weekly Letter

Banking Structure in the West

Banking is more decentralized in the U.S. than in any other developed country because of restrictions on interstate branching and the power of states to make their own banking laws. Such a combination can influence market structure and the level of competition in banking which in turn affect prices, profits, and offerings of financial services.

The nine western states of Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, and Washington, make up the Federal Reserve System's 12th District. These western states, in general, have not embraced extremely restrictive banking laws. They also share the experience of rapid economic growth. Combined, these legislative and economic characteristics have given these states distinctive banking structures. A comparison of their banking structure with that of the rest of the country therefore might shed light on the effects of current legislative and economic changes on the national banking structure.

Branching: U.S. versus the West

A major difference between banking laws in the West and those in the United States historically has been the extent to which branching was permitted. In about a quarter of the fifty states, only unit banks (banks with one full service office) were allowed in 1980. About the same number of states limited the maximum distance bank branches could locate from their main office. The remaining states, including all the western states, permitted some form of statewide branching.

The few branching limitations that did exist in the last decade in some western states could be circumvented, albeit at a cost, through the formation of bank holding companies. These companies geographically expanded by acquiring or establishing banks in other areas. In Utah and Oregon, for example, where *de novo* (new) bank formation is not restricted, bank holding companies used that method to circumvent restrictions on branching outside a bank's home office area. As a result, these states have large numbers of *multi*-bank holding companies. In fact, while the average state percentage of deposits held by multi-bank holding companies in 1980 was 33 percent in the West as a whole, it was 67 percent in Utah and 80 percent in Oregon. In Washington, there historically have been restrictions on bank holding company formation as well as on branching, although branch-swapping has allowed some banks to enter each other's territories.

Such methods of circumventing branching restrictions prevail in restrictive states outside the 12th District as well. On average, however, the restrictions elsewhere appear to have been more effective than they were in the West. Banking organizations operated an average of 3.8 offices in 1980 in the U.S. as a whole; they operated an average of 12.7 in the West in the same year.

Western economic growth

Throughout its history, the West has also been distinguished by rapid economic growth. In the last decade alone, its population surged 23 percent and its personal income jumped 66 percent. The respective growth rates for the U.S. were only 11 and 48 percent. Such rapid growth has probably contributed to the continued permissive western attitudes toward new bank entry and branching as both present less of a perceived threat to established organizations in good economic times.

Liberal regulations resulting from this environment in the West have not led to the inefficient, grossly concentrated markets feared by some opponents of national financial market deregulation. Instead, the combined evidence from western patterns in new bank entry, branching services, deposit shares, and non-bank competition suggest little that is consistent with this view.

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New bank entry

During the last decade, the formation of new banks has led to only a slight (7 percent) increase in the total number of banks in the U.S. (after taking account of all mergers and acquisitions). In contrast, the number of Western banks increased at a much faster rate, from 421 to 817—a 94-percent jump.

The faster growth trend in the 12th District appears to contradict the notion that entry of new banks will be stifled in states where the expansion of existing banks can be achieved through branching. Although it is true that new entry was greater in percentage terms in the more restrictive branching states of Utah, Washington, and Oregon than in the liberal branching states, there has been active foreign and domestic *de novo* entry throughout the District. Over 200 new banks have opened for business in California in the last decade, for example.

Branching services

Another distinctive feature of western banking concerns the prevalence of branching services. It is commonly argued that there are economies of scale in providing branch services and that restrictive branching laws restrain the exploitation of such economies. Thus, one would expect states with liberal branching laws to have more bank branches per capita than other states. Western states, however, have *lower* branch-to-population ratios than other states. The number of branches per 100,000 people in the West is less than 21; in the U.S., it is 25.

This apparent paradox can be explained by the high concentrations of population in urban areas in the West. Eighty-six percent of Westerners live within metropolitan areas, whereas only 74 percent do so nationwide. Individual western branches can, therefore, serve a greater number of customers. A comparison of branch-to-population ratios in states within the 12th District support this explanation. California, Nevada, Arizona, and Hawaii, all with very high percentages of the population living in metropolitan areas, have lower branch-to-population ratios than Idaho and Alaska where the percentages of people living in metropolitan areas are small.

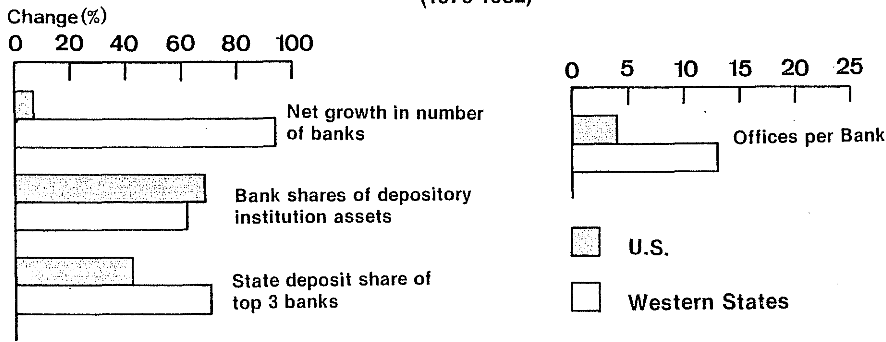
Deposit share concentration

The existence of some economies of scale in branch banking is more firmly corroborated by evidence on bank market shares in the West. If there were economies of scale in branch services, liberal branching regulations should be associated with higher concentrations of deposit shares per banking organization because they permit banks to reach larger, and presumably more efficient, scales. For example, the share of deposits owned by the top three banks in each of the Western states in 1980 was 70 percent on average, while the share for all 50 states was only 42 percent.

State concentration ratios within the West also tended to vary inversely with the degree of branching restriction. The more restrictive states of Utah, Washington, and Oregon had the lowest three-bank concentration ratios in the West of 60, 58, and 62 percent in 1980, respectively. This suggests that the removal of branching restrictions would indeed lead to greater shares of deposits held by large banks and raises the issue of the consequences of such increased concentration for the effectiveness of competition. However, the effect of liberal banking laws on effective competition is more complex than the preceding comparisons suggest.

Effective competition

First, the usual measure of concentration—the deposit share held by the top few banks—may not reflect adequately the effective level of competition. This is because it does not distinguish between the case where a few large banks exist without any small-bank rivalry and the case in which there are numerous small rivals. A more complex index, the Herfindahl index, attempts to distinguish between such cases on the grounds that even a small bank can be an effective actual or potential threat to a large institution. Using such a measure, the liberal branching states



of the West differ little in competitiveness from their less liberal counterparts. Indeed, California, a liberal branching state, has been as "competitive" as its traditionally more restrictive counterparts—Oregon, Utah, and Washington.

Second, state-level concentration measures may be less relevant to the assessment of effective competition than the concentration levels at the local level, where much of the rivalry for consumer and small business customers takes place. There is mixed evidence for this observation in the Twelfth District. In 1981, banks in California and Arizona (two "liberal" branching states) actually faced lower concentrations of bank power (by the Herfindahl measure) in metropolitan areas than banks in the more restrictive state of Oregon. Although such comparisons do not hold consistently throughout the District, such a result would not be unexpected when branching is limited to the county or metropolitan area in which the head office is located. Such a restriction limits the number of potential entrants from outside the market and may limit the effectiveness of branching restrictions in preserving effective competition.

Moreover, as an adjunct to liberal branching laws, the West has encouraged non-bank and foreign bank competition, further promoting vigorous competition in financial markets. The strength of non-bank competition may be responsible for the smaller share of total financial institution deposits held by banks in the West compared to banks in the U.S. Whereas banks nationwide owned 68 percent of all depository institutions' assets in 1980, banks in the West could claim only 61 percent.

Foreign banks have also been aggressive in Western banking through branch bank networks and active agency and representative offices. Although 95 of the 130 major foreign banks in the U.S. in 1981 had established New York as their home state, 11 others chose western locations. These, too, provide effective and sophisticated competition for the domestic banks.

Implications

An evaluation of the western banking experience provides several possible (although ambiguous) lessons for national banking policy. First, although liberalizing branching restrictions (on a state-by-state or national basis) would very likely raise national and state deposit share concentration levels, by some measures effective competition at the local market level may not be severely compromised. (In addition, there appear to be economies of scale in banking that might otherwise go unexploited.) Evidence for this conclusion lies in the poor correlation between state and metropolitan levels of concentration in the West. The poor correlation results because as banks expand their branching networks outside their home territory, they face more metropolitan competitors. National statistics already reflect this situation. While the state market share of the top five banks in the fifty states has increased only 0.1 percent on average in the last decade, the average metropolitan share of the top five banks has fallen between 3 and 7 percent in every state.

Second, we can find no evidence that the entry of new banks is foreclosed by liberal branching legislation. Throughout the West, there has been active entry of new, small banks even in those states where such entry is not simply a vehicle to circumvent branching restrictions.

Finally, non-bank depository institutions have shown themselves to be effective market participants in the West, even in the earlier decade when their deposit taking and lending activities were more constrained than they are today. On balance, further liberalization of branching, and asset and deposit-taking powers seems unlikely, therefore, to lead to overly concentrated banking markets and the poor quality banking services many fear.

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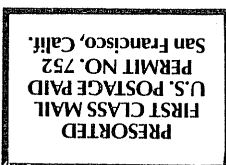

FIRST CLASS

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/3/82	Change from 10/27/82	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	161,741	− 322	+ 8,304	5.3
Loans (gross, adjusted) — total#	142,149	− 252	+ 9,603	7.2
Commercial and industrial	45,518	− 99	+ 5,316	13.2
Real estate	57,534	− 16	+ 2,431	4.4
Loans to individuals	23,414	+ 21	+ 102	.4
Securities loans	2,278	− 30	+ 441	24.0
U.S. Treasury securities*	6,648	+ 30	+ 1,061	19.0
Other securities*	12,944	− 100	− 2,360	− 15.4
Demand deposits — total#	42,165	+3,433	+ 789	1.9
Demand deposits — adjusted	28,658	+ 654	+ 445	1.6
Savings deposits — total	32,545	+ 824	+ 2,726	9.1
Time deposits — total#	100,496	+ 406	+ 15,295	18.0
Individuals, part. & corp.	90,215	+ 337	+ 12,920	16.7
(Large negotiable CD's)	37,596	+ 121	+ 5,051	15.5

Weekly Averages of Daily Figures	Week ended 11/3/82	Week ended 10/27/82	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	81	123	62
Borrowings	39	3	50
Net free reserves (+)/Net borrowed(−)	42	120	12

* Excludes trading account securities.
# Includes items not shown separately.

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