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The Impact of Interstate Banking and Branching Reform: Evidence from the States

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Federal interstate banking and branching reform is about to become a reality, with the first phase of new legislation going into effect later this year. Past experience at the state level suggests that reform will accelerate the pace of industry consolidation but may not lead immediately to nationwide banking.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, signed into law by President Clinton on September 29, eliminates most restrictions on interstate bank acquisitions and makes interstate branching possible for the first time in seventy years. The act will permit bank holding companies (BHCs) to acquire banks anywhere in the nation as of September 29, 1995, subject to certain limitations, and will invalidate the laws of thirty-six states that currently allow interstate banking only on a reciprocal or regional basis.[1] As of June 1, 1997, BHCs will also be able to convert their banks in various states into branches of a single interstate bank.[2]

Some advocates of reform claim that the 1994 act will make U.S. institutions more efficient by allowing them to convert their bank subsidiaries into bank branches and thus eliminate duplicative overhead costs. Others argue that it will promote safety and soundness in the banking industry by removing barriers to geographic expansion and helping BHCs better diversify their assets and liabilities. But whether the new law will in fact improve bank efficiency and asset diversification substantially has yet to be demonstrated: previous research, which has focused largely on the comparative cost structures of BHCs and branch banks, has yielded no conclusive evidence regarding reform's likely impact.

This edition of *Current Issues* seeks more concrete evidence of the effects of banking reform by tracking the *actual* changes in bank behavior that followed the liberalization of state branching and interstate banking laws from 1988 to 1993. Although federal banking and branching laws have not changed for decades, many states lifted restrictions on branching within their borders and began to permit out-of-state institutions to acquire their banks during the 1980s. Data on BHCs' responses to state-level reforms enacted between June 30, 1988, and June 30, 1993, provide a laboratory in which to study the impact of these changes and to draw some inferences about the likely effects of the Riegle-Neal act.[3] The analysis yields the following findings:

- BHCs responded quickly and in large numbers to intrastate branching reforms by consolidating two or more banks within at least one state in which they operated.

- However, fewer BHCs took advantage of interstate banking reforms enacted during this period to expand into additional states. Moreover, most of the first-time interstate entries observed were delayed responses to reforms enacted before June 1988.

- BHCs that did enter new states during the period typically acquired banks in neighboring, rather than distant, states.

These findings provide a basis for projecting the likely speed and breadth of the 1994 federal reform's impact on U.S. banks. Specifically, they imply that federal reform will speed industry consolidation by facilitating mergers of banks located in different states but may not lead immediately to the formation of coast-to-coast banking companies through bank acquisitions.

How BHCs Responded to State Reforms, 1988-93

The analysis focuses on the relationship between changes in state branching and interstate banking laws and changes in BHC structure. Y-9C[4] and call report data were used to construct snapshots of the structure of all domestic and foreign-owned BHCs operating two or more commercial banks in the United States on June 30, 1988, and/or June 30, 1993.[5] These dates mark the beginning and end of a second wave of changes in states' bank branching and interstate banking laws following an initial period of liberalization in the early to mid-1980s. Additional data from the National Information Center database shed light on the timing of changes in the ownership and structure of BHCs' commercial banking operations during the period. The Federal Reserve Board provided most of the information on state laws, although several state banking agencies verified the Board's information. Overall, the analysis gives a mixed picture of BHCs' responses to reform.

Gradual, localized expansion across state borders. Interstate banking activity, which was already substantial by June 1988, grew between June 1988 and June 1993. The number of BHCs that operated commercial banks in two or more states increased from 134 to 159 during this period. The growth of interstate activity looks more impressive when measured as an increase in banking assets held by interstate BHCs. The share of total U.S. banking assets held by interstate BHCs rose from 56.8 percent on June 30, 1988, to 88.5 percent by June 30, 1993.

The apparent preference of BHCs for incremental, regional expansion . . . casts some doubt on the potential of reform to yield substantial diversification of banks' assets and liabilities in the near term.

Ninety-five BHCs, many of which were already operating across state borders on June 30, 1988, moved into new states during the period, executing a total of 135 first-time interstate entries. Nine of these were de novo entries; the other 126 represented acquisitions of

Table 1

Pattern of BHC Geographic Expansion between June 30, 1988, and June 30, 1993

	States Allowing Entry as of 6/30/88	States Allowing Entry after 6/30/88	Total
Panel A: All First-Time Entries Occurring During the Period			
Expansion into nearby vs. distant states:			
Entries into neighboring state (% all entries)	74 (54.8%)	27 (20.0%)	101 (74.8%)
Entries into noncontiguous state (% all entries)	20 (14.8%)	14 (10.4%)	34 (25.2%)
Expansion within vs. between geographic regions:			
Entries into other state in BHC's region (% all entries)	67 (49.6%)	30 (22.2%)	97 (71.9%)
Entries into state outside BHC's region (% all entries)	27 (20.0%)	11 (8.1%)	38 (28.1%)
Expansion within vs. between subregions:			
Entries within BHC's subregion (% all entries)	51 (37.8%)	20 (14.8%)	71 (52.6%)
Entries into state outside BHC's subregion (% all entries)	43 (31.9%)	21 (15.6%)	64 (47.4%)
Total	94 (69.6%)	41 (30.4%)	135 (100.0%)
Panel B: Time between Reform and Entry by Out-of-State Bank Holding Company			
Average number of months between time that entry became possible under state law and entry date	49.8	15.9	
Minimum	6.0	3.5	
Maximum	86.5	59.5	

Sources: Federal Financial Institutions Examination Council, Reports of Condition and Income; National Information Center Database.

existing banks. Table 1 classifies each of these entries according to the laws of the home state of the expanding BHC and the state it entered, and distinguishes between those entries that could have been accomplished under existing law as of June 30, 1988, and those made possible by reforms enacted during the period studied. The data presented in Panel A indicate that fewer than one-third of the interstate entries observed were made possible by state laws enacted during the period. Most of the entries observed represented delayed responses to state laws enacted before June 30, 1988.

Panel A also shows that BHCs exhibited a preference for intraregional, rather than interregional, expansion during this period. Over 70 percent of first-time entries were made within the geographic region in which the BHC's home state was located; 50 percent of these entries occurred within the BHC's own subregion.[6] A more meaningful way to evaluate the expansion patterns of BHCs may be to examine the share of BHC entries made into neighboring states rather than within geographic regions, because regions are somewhat arbitrarily defined. Nearly 75 percent of all first-time entries represented moves into a neighboring state.

The data presented in Panel B indicate that many BHCs did not move into new states until years after entry became possible. BHCs may have been slow to respond because of residual barriers to entry: many states that began to permit interstate banking after June 1988 continued to prohibit some types of interstate acquisitions, such as purchases of recently formed banks or acquisitions that would boost the acquirer's share of the state's deposits above a specified ceiling. In some cases, the lag between reform and entry may also reflect the presence of firm-specific factors (insufficient capital, absence of suitable acquisition targets) or market-specific conditions (recession) that discouraged interstate acquisitions. This analysis does not control for such factors.

The speed with which BHCs responded to state branching reforms by consolidating their banks suggests that many institutions expected to gain substantial benefits from bank consolidation and branch conversions.

BHCs' preference for expansion into nearby states may also reflect the fact that many states limited access to their markets to institutions located within nearby states for at least part of the period studied. To investigate this possibility, the analysis in Panel A of Table 1 is repeated in Table 2 for the subset of BHC entries that occurred at a time when the host state did not restrict access on a geographic basis. As Table 2 indicates, most of these entries were made within the BHC's region or between neighboring states. This result suggests that BHCs might have tended to expand into nearby states even in the absence of the regional compacts formed by many southern and midwestern states. The apparent preference of BHCs for incremental, regional expansion is not surprising; many banking markets span neighboring states, and nearby banks may be less costly or less risky to acquire than those in more distant locations. Nevertheless, this result casts some doubt on the potential of reform to yield substantial diversification of banks' assets and liabilities in the near term.

Table 2

All First-Time Entries into New States Where State Law Did Not Impose Regional Restrictions on Interstate Acquisitions

	Total
Expansion into nearby vs. distant states:	
Entries into neighboring state (% all entries)	45 (61.6%)
Entries into noncontiguous state (% all entries)	28 (38.4%)
Expansion within vs. between geographic regions:	
Entries into other state in BHC's region (% all entries)	42 (57.5%)
Entries into state outside BHC's region (% all entries)	31 (42.5%)
Expansion within vs. between subregions:	
Entries within BHC's subregion (% all entries)	32 (43.8%)
Entries into state outside BHC's subregion (% all entries)	41 (56.2%)
Total	73 (100.0%)

Sources: Federal Financial Institutions Examination Council, Reports of Condition and Income; National Information Center Database.

Rapid, widespread consolidation within state borders. Although interstate branching has largely been prohibited by federal law since 1927, some insight into the potential impact of federal branching reform can be derived by analyzing BHCs' responses to intrastate branching liberalization. Thirteen of the sixteen states that prohibited statewide branching as of June 30, 1988, changed their laws to permit statewide branching through bank mergers during the period studied. By comparing the rate of bank consolidation in these thirteen states with that observed in states already permitting statewide branching as of June 30, 1988, it is possible to assess the speed and breadth of BHCs' responses to reform.

Nearly a quarter of the 4,790 banks owned by BHCs with multibank operations in the United States on June 30, 1988, had been merged into other institutions by June 30, 1993. This consolidation boom clearly reflects the erosion of banks' market share in both deposit and lending markets during the 1980s as a result of deregulation and increased competition by nonbank firms. Much of the consolidation could not have occurred, however, without specific state reforms: nearly two-thirds of the banks merged into other institutions were located in the thirteen states that reformed their branching laws during the period observed.[7] As Panel A of Table 3 indicates, the consolidation rate in these thirteen states—measured as the share of all banks in existence at June 30, 1988, that were merged into other banks during the period—was higher than the rate observed in states that allowed statewide branching throughout the period. This difference was statistically significant at the 5 percent level.

If branching restrictions prevent BHCs from consolidating their operations as much as they would like, we should see branch conversions increase sharply immediately after the Riegle-Neal act takes effect and then taper off over time. The data presented in Panel B are consistent with this premise: conversion rates were generally higher for states that had recently reformed their branching laws than for those that had allowed statewide branching for some time.

The speed with which BHCs responded to state branching reforms by consolidating their banks suggests that many institutions expected to gain substantial benefits from bank consolidation and branch conversions, although the data do not provide any information on the size or nature of these benefits.

If pent-up demand for interstate branching is substantial, then the Riegle-Neal act may speed consolidation even more than the data on intrastate mergers suggest.

This perception was not universal, however; some BHCs did not merge their banks even after state law permitted statewide branching through mergers. In some cases, the costs of converting subsidiaries to branches may have exceeded any savings from consolidation. In other cases, the BHC may have chosen to maintain separate subsidiaries in order to reap the benefits of decentralized management, or to operate both national and state banks in a given state in order to arbitrage current or future differences in state and national bank powers.

Table 3

Consolidation of BHCs' Banks within State Borders between June 30, 1988, and June 30, 1993

Panel A: Number (Percentage) of Banks Consolidated in States with Different Bank Branching Laws

	In 35 States Allowing Statewide Branching as of 6/30/88	In 13 States Allowing Statewide Branching as of 6/30/93	In 3 States Prohibiting Statewide Branching as of 6/30/93[a]
Banks owned by BHCs on 6/30/88 that:			
Still existed on 6/30/93	989 (69.4%)	1815 (63.5%)	429 (85.0%)
Same owner	51.1%	46.9%	58.4%
New owner	18.2%	16.6%	26.5%
Had been merged with other banks by 6/30/93	301 (21.1%)	691 (24.2%)	65 (12.9%)
Same owner	16.5%	18.7%	8.7 %
New owner	4.6%	5.4%	4.2%
Failed/closed by 6/30/93	136 (9.5%)	353 (12.3%)	11 (2.2%)
Total	1426	2859	505

Panel B: Banks Consolidated in States That Allowed Statewide Branching through Mergers at Different Times

	State Allowed It before 1/1/83	State Enacted It between 1/1/83 and 6/30/88	State Enacted It between 7/1/88 and 12/31/89	State Enacted It between 1/1/90 and 6/30/93	State Prohibited It as of 6/30/93
Number of banks as of 6/30/88	406	1020	1404	1455	505
Percentage of banks consolidated by 6/30/93	18.2	22.3	25.8	22.7	12.9

Sources: Federal Financial Institutions Examination Council, Reports of Condition and Income; National Information Center Database.

[a] Arkansas, Iowa, and Minnesota prohibited statewide branching throughout the period but liberalized their branching laws during this time, making consolidation within a part of the state possible.

Mixed Implications for Federal Reform

Between June 30, 1988, and June 30, 1993, BHCs responded to state branching liberalization relatively quickly, and in large numbers, by consolidating some or all of their banks in different parts of those states. BHCs were somewhat slower to respond to interstate banking liberalization by expanding into new states. Although most of the bank consolidation that occurred can be traced to branching laws enacted during the period, most of the first-time BHC entries into new states during this time could have been accomplished under state laws enacted before June 30, 1988.

The extent of the consolidation activity observed among BHCs is consistent with the claim that branching liberalization will benefit many institutions, presumably by enabling them to reduce their operating costs as they convert bank subsidiaries into bank branches. In states that do not enact laws prohibiting interstate branching before the June 1, 1997, deadline established by Riegle-Neal, federal reform will take the banking industry from zero to full interstate branching. In contrast, many states that enacted statewide branching during the period studied had previously allowed limited branching within their borders—for example, permitting banks to branch within counties, or between neighboring counties. If pent-up demand for interstate branching is substantial, then the Riegle-Neal act may speed consolidation even more than the data on intrastate mergers suggest.

How federal reform will affect the geographic diversification of banks' assets and liabilities is more difficult to predict. Diversification will only occur as BHCs move into states whose economic characteristics are not strongly correlated with those of the states in which they already operate. Since neighboring states' economies are likely to be more similar than those of states located in different regions of the country, the speed with which diversification occurs will depend on how quickly BHCs begin to expand outside their core operating areas. Past experience at the state level suggests that BHCs may continue to expand primarily into nearby states even after interstate banking reform takes effect in September. However, by making nationwide banking possible for the first time, the law may alter the calculus behind BHCs' expansion decisions and prompt some BHCs to expand quickly into other regions of the country in order to establish national banking franchises.

Notes

1. A reciprocal law allows entry by an out-of-state BHC only if that BHC's home state extends similar access to the state's own institutions. Regional laws allow entry only by BHCs based in states located in a specified region and prohibit entry by BHCs located in other areas.

2. The law will also permit BHCs and banks to establish de novo, or newly chartered, interstate branches to the extent authorized by state law.

3. Some states lifted restrictions on de novo branching within their borders during this period. However, this analysis examines only state reforms that permitted branching through mergers of existing banks, since the Riegle-Neal act explicitly authorizes only this mode of interstate branching.

4. Y-9C reports are filed quarterly by all BHCs with consolidated assets of $150 million or more and by certain other multibank holding companies. These reports reflect the BHC's financial condition on a consolidated basis.

5. As of June 30, 1988, 852 BHCs that were not owned by another company operated two or more commercial banks in the United States; by June 30, 1993, this number had risen to 875.

6. Regions and subregions are defined according to the Census Bureau's guidelines.

7. Most of these thirteen states had previously allowed some degree of branching (through bank mergers) within cities, counties, or regions of the state; some of the mergers observed in these states might have occurred even without branching liberalization.

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