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Interstate Branching and Banking Trends

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The United States banking system has been undergoing a significant transformation during recent years. This transformation is largely the result of two regulatory changes that the U.S. Congress passed during the 1990s. The first of these changes came with the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act in 1994, while the second came with the passage of the Gramm-Leach-Bliley Financial Services Modernization Act in 1999. The Riegle-Neal Act changed the scale of banking by giving banks the ability to open interstate branches, while the Gramm-Leach-Bliley Act changed the scope of banking by repealing the Glass-Steagall Act's separation of commercial from investment banking. While the Gramm-Leach-Bliley Act has received more recent attention than the Riegle-Neal Act, the latter has likely had a greater influence on America's banking system since the changes it has prompted have had more time to take effect.

Prior to the passage of the Riegle-Neal Act, American banks' ability to operate branches had been severely limited. Virtually all banks were prohibited from operating branches across state lines and in many states banks were prohibited from operating any branches at all (even within the same county or city). A result of these prohibitions was an American banking system comprised primarily of a large number of relatively small banks.

The Riegle-Neal Act set the stage for a rapid transition of the American banking system from "small banking" into "large banking" by giving banks permission to operate widespread interstate branching networks for basically the first time in U.S. history. Although the Act is only eight years old and only fully went into effect in 1997, it has already caused several significant changes in the U.S. banking system. For example, in January 1994, prior to the passage of the Riegle-Neal Act, there were ten commercial banks operating a total of thirty branches across state lines. As of June 2002, there were 327 commercial banks operating a total of 21,415 interstate branches. The impact of the Act can also be seen in the Greater Grand Rapids metropolitan area (GGR). The most notable impact has been the acquisition of Old Kent Bank by Fifth Third Bank in 2001, but there have been additional changes as well. Since 1994, six banks with headquarters located outside of the State of Michigan have entered the GGR banking market. Although these five banks represent only 17% of all banks in GGR, they hold 58% of all deposits in the GGR market. It is clear that the Riegle-Neal Act is changing the face of both the U.S. banking system as well as our local banking system.

Most of the increase in interstate branching has come as a result of banks acquiring or merging with banks in other states. A result of these mergers and acquisitions has been a substantial decrease in the number of small banks and the total amount of deposits placed with these small banks. In June 1994 there were 8,614 FDIC-insured financial institutions (including commercial banks and savings institutions) with deposits of less than $100 million. By June 2002 the number of institutions with deposits of less than $100 million had fallen to 4,916. As can be seen in Figure One, during this same eight-year span the proportion of deposits at these small financial institutions as a percentage of deposits at all institutions fell from 10.5% to 4.5%. While small institutions have been declining both in number and in influence, the opposite is happening for the largest financial institutions in America. The number of institutions with more than $10 billion in deposits has grown from sixty-four in 1994 to one hundred in 2002. Even more significantly, the total amount of deposits at these largest institutions has increased from 30% of total deposits to almost 60% of total deposits. The trend is obvious, the United States is shifting dramatically away from its traditional system of small financial institutions to a new system where very large institutions are prevalent.

An important question that must be asked is whether this trend toward bank consolidation will reduce or increase competition among banks. The traditional argument against allowing banks to operate widespread branching networks has been the fear of "money trusts." That is, Americans seem to have had an aversion to allowing financial institutions to become large, at least in part because they feared that large banks would be able to exploit monopoly power and influence over small depositors and businesses.1 It has been also argued, however, that by limiting the ability of banks to branch, the American banking system was actually less competitive than it would have been with the presence of large branching networks. The rationale behind this argument is that restrictions on branching prevented banks from reaching out to enter new markets and, therefore, protected the banks already in these markets. Without the threat of competition from out-of-town banks, the local banks could exercise market power.
Which argument is correct? Have banking markets become more competitive or less competitive as a result of the elimination of interstate banking restrictions? At first blush it might appear that markets have become less competitive as the number of all financial institutions in the United States has declined from 12,933 in 1994 to 9,455 in 2002. The decline in the number of financial institutions per capita is illustrated in Figure Two. It can be seen that the ratio of persons per financial institution has increased in the United States from one financial institution per 20,000 people to one financial institution per 30,100 persons. These ratios have also increased for the State of Michigan to one institution per 51,800 persons and very slightly for the Greater Grand Rapids metropolitan area to one institution per 30,700 persons.

Although the above figures seem to indicate that the banking system is becoming less competitive, this is not necessarily the case. The mere number of financial institutions does not automatically reflect the market power of these institutions. It is very possible that a market area might have many small banks but be dominated by one or two very large banks. In this case the number of financial institutions would suggest that the market was competitive even though most of the market share was going to the small number of large banks. To control for this situation, economists often use a measure of market concentration called the Herfindahl-Hirschman Index (HHI). This index is derived by taking the sum of the squares of market share for each business in a given market. The higher the HHI, the more concentrated (and hence less competitive) a market is seen to be. The U.S. Department of Justice uses the HHI to evaluate mergers. If the HHI is less than 1000 for a market, the Department of Justice generally considers that market to be competitive. Markets with HHI values between 1000 and 1800 are viewed as moderately concentrated, while markets with an HHI above 1800 are generally considered highly concentrated.

Figure Three presents the HHI values for Michigan’s nine metropolitan areas as of June 2002. It can be seen that the banking market in the Greater Grand Rapids area is exactly at the median in terms of market concentration. It is more concentrated than other comparable areas including Lansing and Kalamazoo/Battle Creek, but it is slightly less concentrated than Detroit and significantly less concentrated than other markets.

To see if the introduction of interstate banking has created significant changes in bank concentration in GGR, I calculated the HHI for GGR from 1994 to 2002. From the results presented in Figure Four, it can be seen that the GGR banking market has been moderately concentrated for the past decade without significant trends upward or downward. It can be observed, however, that the highly publicized acquisition of Old Kent Bank by Fifth Third Bank in 2001 appears to have actually lessened banking market concentration in the Greater Grand Rapids area. This is almost certainly because the Federal Reserve Board stipulated that Fifth Third had to divest several branch offices in order to gain approval for the acquisition.

Overall, the findings indicate that the competitiveness of the Greater Grand Rapids banking system has not been significantly affected either positively or negatively by the introduction of interstate branch-banking networks that was prompted by the Riegle-Neal Act. This negligible effect is likely largely because Michigan, unlike many other states, allowed intrastate branching networks to develop for several decades before the Riegle-Neal Act was enacted.

This argument was promoted by the Popularist movement a century ago, but it can also be traced back as far as Thomas Jefferson. It is interesting that in no other country except America has there seemed to be such an aversion to large-scale banking and that nationwide branch-banking systems existed in all other industrialized nations by the early part of the twentieth century.