Prepared Statement on State-Wide Branch Banking in Pennsylvania

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I appreciate the opportunity to present my views on the subject of state-wide branch banking. The subject has interested me for a number of years not only because it lies within the range of my professional interests, but also because there are few subjects that offer a better example of the wide gap that often exists between the law and informed, professional opinion.

Laws that prevent competition frequently harm users of the regulated good or service by reducing the amount and quality of service offered or by raising the price the users pay for services of a given kind or quality. Geographical restrictions on bank branching in Pennsylvania have this effect. The laws, generally defended as a means of protecting consumers, farmers and small businessmen, more often than not have the opposite effect. They raise the costs and reduce the range and quality of service available to consumers, farmers, and businessmen.

Why is there a great difference between the intent of the laws restricting bank branches to contiguous counties and the actual effect of the law? The answer is that the law is based on a hypothetical situation that differs markedly from the known facts. The common allegation is that branch banking drives out competition. The simplest, most frequent version of the argument is that the large, branch bank acts as a predator. By offering low prices, the branch is able to drive out the local competitor, siphon off funds obtained from the local community, raise loan rates, and in other ways act
against the best interests of the community in which the branch is located. These facts, if true, would be more than enough justification for eliminating branch banking.

But the allegations are not true. Few subjects have been researched more thoroughly in recent years than the subject of banking markets. During the early sixties, and continuing throughout the decade, we had the benefit of an unusual combination of circumstances. Various Federal Reserve banks encouraged the development of uniform accounting procedures. These procedures permitted the study of bank costs -- both total costs and the costs of particular banking services. Comparisons of data for states that restrict branching entirely, that limit branching to particular geographical areas, or that permit state-wide branch banking has provided evidence on costs per unit of service under the varying restrictions on branching or the absence of such restrictions.

At about the same time, substantial changes in the attitudes and regulations of the Comptroller of the Currency permitted a considerable increase in the amount of branching, merger and new entry by national banks, where permitted by state law. These developments were based on predictions made by the staff of the Comptroller's office that competition would be increased and that service to consumers, farmers and business would be improved if competition were increased. The actions based on these predictions have been studied and restudied. I take this opportunity to summarize my conclusions on the issues currently of importance to the committee
Three Main Issues

Studies of banking markets provide little justification for restrictions on branching. Two of the main conclusions of studies of banking regulation are that (1) existing banks offer more services where entry or branching is permitted and (2) that when small unit banks become branches of larger banks, banking service generally increases to the public in the communities previously served by the unit banks.

The conclusions are based upon careful analysis of several issues. One of these issues, a particularly critical issue, is the relation between costs of providing services and the size of bank. A second is the range of services offered to consumers and the costs paid for the services. A third is the service offered to the local community.

Economies of Scale

The technical name for the relation between costs and size is economies of scale, and the importance of the relation is easy to explain. If there are substantial economies of scale in banking, costs of providing a service decline with the size of a bank. Large banks have considerable advantages over small banks. They would be able to underprice small banks and drive them out of business. On the other hand, if there are few economies of scale, or if economies of scale are slight, competition will not eliminate small banks. Many sizes and types of banks can continue to prosper and provide service.

Closely related to studies of the comparative costs of large and small banks are studies of costs of branch and unit banks. If branch banks have
cost advantage over unit banks of similar size, branch banks would be able to reduce the cost of banking services. Unit banks would be driven out of business. Consumers would have lower costs but fewer banks offering service.

One of the most frequently noted facts about the U.S. banking system is the diversity of bank sizes and types that persists in the industry. If there are significant economies or dis-economies of scale in banking, or if branch banks had significant advantages over unit banks, we would not expect to find the size and diversity that is characteristic of the U.S banking system. In states that permitted branching, branch banks would drive unit banks out of business, and large banks would drive small banks out of business in unit banking states. Nothing of the kind has happened. In the early 1960's more than half of the banks held deposits of less than 5 million dollars. More impressive is the fact that new entrants into banking show a range of sizes for initial capital suggesting that they expected to operate over a broad range of size groups. Moreover, data show that more than 20% of the new national banks chartered in 1962 -- when restrictions on entry into banking were relaxed at the national level -- serve areas of the country with less than ten thousand people. Their choice was to enter business in communities of the size in which ten thousand of the approximately twelve thousand existing banks were found at the time. At the other end of the spectrum, 17 of the 64 new entrants chose cities with populations of one million or more. These data suggest that opportunities for profitable new service existed over a wide range of bank sizes.

Studies of costs, profitability or rate of return generally point in the same direction. If banks could lower costs by branching, we would expect unit banks to be absorbed by branches in states that permit branch banking.
Branch banking has grown very slowly, however. While the ratio of branch banks to total banks grew from 1% to approximately 40% in the past 70 years, the ratio has shown only a slight tendency to accelerate. Several studies show that this finding is entirely consistent with the cost structures of banks. Branch banks have been found to have higher costs than unit banks of similar deposit size.

To summarize, the data that have been generated are inconsistent with the view that branch banks have substantial competitive advantage over unit banks of similar or smaller size. A careful study in the early 1960's concluded that a unit bank with less than two million dollars in deposits would have average costs approximately equal to a branch bank with deposits of about 5 to 10 million dollars. A unit bank with 50 to 100 million dollars in deposits has average costs comparable to those of a branch bank with 200 million to 500 million in deposits. The reasonable conclusion from these studies is that the additional costs of operating branch banks are eventually offset by economies of scale. As a result, small unit banks and large branch banks may have approximately the same costs of operation.

Service Charges and Services

A second issue involves service charges and the cost per unit of service at different types of banks. This is a complicated issue because all banks do not offer the same range of services, and all customers do not wish to have the same range of services offered. Some customers prefer to pay a fee and receive services. Others prefer to do their banking at minimum cost and want few services.
A study for the House Banking and Currency Committee in the 1960's found that large banks had higher service charges than small banks, that branch banks generally had higher service charges than unit banks, and that differences between types of banks generally declined as the size of the depositors average and minimum balance increased. On the average, small depositors paid somewhat higher service charges at city banks and particularly at branch banks in large cities. But, the differences in cost are not large. The largest average cost reduction available to an average small depositor -- a depositor with a $200 minimum balance, $300 average balance -- who writes 10 checks and makes 2 deposits per month was 81¢ per month. This is the difference between the average fee for service at banks classified at the high and low ends of the spectrum.

In interpreting these facts, it is important to bear in mind that banks that have the highest service charges generally offer the largest range of services of interest to large and small depositors. Data on service charges from the mid-1960's can be interpreted as the outcome of a search, or selection, process by means of which depositors select banks that offer the package of services they desire. Banks with similar costs of operation compete by offering more services at higher cost or fewer services at lower cost.

A particularly interesting comparison is a study of Nassau County, New York before and after New York City banks were permitted to expand into the county. The findings for the county study were that there had been a significant increase in the number of banks and branches and consequently in the amount or convenience of banking services offered to consumers in
Nassau County. Accompanying the increase in service was a reduction in installment loan rates paid by borrowers and a gradual increase in interest rates on time and saving deposits received by depositors.

Stepping back from these data to look at the issue rather than the detail, we find the outcome very similar to what we would expect to find under competition. One of the ways in which banks compete is by offering specialized services. The costs of operating a branch bank are roughly the same as the costs of operating a unit bank of smaller size. Consequently, branch banks offer lower rates on some types of loans, but they cannot offer the lowest rates on all types of loans. Branch banks, in the past, generally offered higher rates of interest on consumer and business saving and time deposits, but they generally charged higher service charges for checking accounts. Indeed, if branch banks were able to offer low interest rates on their loans, pay higher interest rates on their deposits and charge lower service charges for their checking accounts they would gradually drive unit banks out of business. Nothing of this kind appears to have happened, or seems likely to happen. Instead, we can expect that if state-wide branch banking is permitted, banking services will be increased at both unit and branch banks and consumers will have more choice. This is the pattern that has been found in previous studies, and there is no reason to expect that it will not be repeated in Pennsylvania.

Service to the Local Community

A third issue is the service to the local community. This is often a heated and emotional issue. Sometimes there is an underlying premise that
loans and deposits ought to be approximately equal in each community. The premise is not attractive. There are growing and declining areas within the state, and within the nation. One function of the financial system, and of the banking system, is to provide the mechanism by which we obtain an efficiency allocation of financial resources within the state and within the country.

The finding, if true, that loans and deposits do not balance within each community has no obvious implication for public policy. Furthermore, it is not clear how one could study this issue. Fifty years ago it may have been plausible to assume that local banks did most of their business within their local communities and that local depositors and borrowers had few options other than those offered in the local community. This is clearly no longer true. Many depositors maintain their balances out of town or out of state. Until Federal regulation imposed ceiling rates on time and savings deposits, many depositors kept thrift accounts in California where thrift institutions paid higher interest rates. Some consumers do their banking near their place of work rather than near their residence.

On the other side of the ledger, there is the behavior of the banking system. Banks long ago developed correspondent relationships to assist the movement of funds from deficit areas to surplus areas. The effect of these developments -- and they have come rapidly as interest rates have risen in the past twenty years -- is to permit banks, even small unit banks, to operate in a regional or national market. The development of bank holding companies is but one of the modern manifestations of the way in which efficiency increases.
The issue about local service is not whether funds are going to be moved but whether they will be moved more efficiently or less efficiently. We must ask the question about local loans and local service in a different way.

How can the state of Pennsylvania, or any other state, assure that a higher percentage of the deposits in a local region will be used to generate loans within that region? The answer is that it can succeed in forcing lending at prevailing market rates within a given area only to the extent that it is able to reduce the services offered to depositors in the area or to reduce the interest rates that depositors receive on their time and savings accounts. For any banks to provide unprofitable services to local borrowers within the region can only be achieved at the expense of the depositors within the region. As soon as the depositors recognize that they can receive more services or more desirable services, or more interest on their deposits by moving their time, saving or demand deposits out of state, the local bank will lose deposits. The bank will then have to reduce its loans to local borrowers.

Conclusion

The central point at issue is whether the financial payments system in Pennsylvania, and in the nation, is to be more rather than less efficient. Improvements in the efficiency of the payments system benefit consumers, businessmen, farmers and citizens generally. Improvements in efficiency can be obtained by increasing competition, and increases in competition can be obtained by permitting state-wide branching.
Similar reasoning, and a similar conclusion can be found in the report of the President's Commission on Financial Structure and Regulation. This broad group of distinguished citizens, after careful study of the issues involved, recommended to the states that they reconsider their branching laws and, as you know, several have now done so.

I believe the citizens of Pennsylvania will benefit from the proposed change in branching laws.