Limited Branching in Minnesota: Its Impact on Banking Consumers

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In 1977 Minnesota policymakers enacted a limited branch banking law, thus ending a half-century ban on branch banking in the state—but not the debate about how branching would affect consumers of banking services. Opponents of branching had long argued that any relaxation of the no-branching law would reduce competition in Minnesota's banking industry and therefore increase the cost and reduce the supply of financial services to bank customers. But proponents of branching had argued that there wasn't much evidence to support that assertion and that the branching ban was itself stopping some Minnesota consumers from getting the banking services they wanted by preventing bank offices from opening in their areas.

This study analyzes developments in Minnesota's banking industry since the passage of the branching law in 1977 to see whether or not the new law has benefited consumers. In particular, we examine the changes in the number and placement of banking offices in Minnesota and the changes in the prices and supplies of banking services. We conclude that allowing Minnesota banks some freedom to branch has so far probably benefited consumers: it has given them many more places to bank, and it does not appear to have adversely affected the prices and availability of their banking services.

Why Minnesota Banned Branching

Minnesota policymakers prohibited branch banking in the state for about 50 years, and this prohibition seems to have been aimed mostly at large banking firms.

The first explicit state action against branching occurred in 1923 and was clearly directed at large national banks. It came in response to a 1922 reinterpretation of the federal banking law, the 1864 National Bank Act. Before 1922 regulators had interpreted that law as prohibiting national banks from branching anywhere. In 1922, however, they reinterpreted the law as allowing national banks to branch within their city limits in states which did not prohibit branching. Since Minnesota state law had never addressed the branching question, large national banks in Minneapolis began to branch. Minnesota policymakers quickly enacted an explicit no-branching law.[1]

Despite this law, a form of multioffice banking very similar to branching was allowed in Minnesota several years later during the national banking crisis. Over 20 percent of all U.S. commercial banks and one-third of Minnesota's banks went out of business in the decade between 1920 and 1930. Policymakers across the nation recognized that many banking offices might be saved if weak banks could be acquired and operated by strong banks. Some states that had banned branching therefore eased their restrictions so that banks could merge. Minnesota chose to maintain its explicit ban on branching but to let banks pool their equity in multibank holding companies. Since these companies generally consisted of a network of affiliated banks, much like branches, this decision can be viewed as a loosening of the branching ban.

Before long, however, the decision was effectively repealed, at least for large banking firms. Two multibank holding companies, Northwest Bancorporation and First Bank System, had formed in Minnesota in

[1]For a historical account of the branching issue, see Fischer and Golembe 1976.

the late 1920s and by 1934 had between them acquired 75 banks. Their rapid growth ended when the banking crisis did. While small multibank holding companies were still allowed to acquire banks, both state and federal regulators became far less willing to permit bank acquisitions by the two large companies.[2] Between 1935 and 1980, these two firms acquired only 25 more banks, one-third the number they had previously acquired.

This obvious concern with expansion by large banks was at the heart of the argument against branch banking, which kept it banned for so long in Minnesota.

Permitting branching, opponents argued, would inevitably let large banks get larger. From experience, they said, we know that branching increases the *concentration* of banking services, that is, the share of the banking market held by the largest firms. As evidence they generally pointed out that the share of a state's total bank deposits held by the state's largest firms was higher where branching was allowed.[3]

That branching would increase concentration in the banking industry was important to opponents of branch banking because they believed the degree of concentration determined the degree of competition in this industry. Their belief was based on the general economic theory that, when entry to an industry is restricted, a high degree of concentration can result in noncompetitive behavior by the largest firms in the industry: those large firms would not have to compete and so would be able to charge consumers higher prices and offer them fewer services than a competitive industry would.[4] Opponents of branch banking noted that entry to the banking industry is restricted by government regulation and so concluded that if branching increased concentration enough, it could well lead to noncompetitive effects.

Although economic theory predicts that high concentration will lead to reduced competition, it does not predict how high concentration has to be for noncompetitive effects to result in any industry. Opponents of branching in Minnesota, however, have apparently considered the degree of concentration in the state's banking industry as already at or past the critical point. Certainly whenever branching was debated—from 1934, when the two largest multibank holding companies held about two-thirds of the state's bank deposits, to the 1970s, when their share had dropped to about one-half—the current degree as measured by this ratio was cited as reason to worry about noncompetitive behavior if branching were allowed in Minnesota.[5]

Arguments for Lifting the Branching Ban

Branch banking did not go undefended in Minnesota over the years it was banned, and by the 1970s, several strong counterarguments to the assertion that it would hurt consumers by allowing noncompetitive behavior had developed.

One counterargument was that concentration in Minnesota's banking industry was simply not as high as opponents of branching thought. This was based on both an evaluation of the measure opponents used and an examination of an empirical study of Minnesota's banking industry.

The measure of concentration which opponents of branching usually cited as "high" in Minnesota, proponents argued, was too narrow to truly reflect the degree of concentration there.[6] That measure, the statewide bank deposit ratio, assumes that just one service, bank deposits, is an adequate proxy for all banking services, that the state is an appropriate geographic market area for all services, and that banks are the only competitors in the market. Proponents questioned all of these assumptions. Banks, they said, offer consumers many different services, and the market for each is likely to be a different geographic size—for some a city, for some a county or the state, and for others the region or even the nation. Perhaps most important, banks are obviously not the only firms competing to offer consumers many "banking" services. Other finan-

[2]Until 1956, multibank holding company acquisitions could be regulated by the state alone. With the Bank Holding Company Act of 1956, Congress shifted this authority to the Board of Governors of the Federal Reserve System, and for the most part, the Fed has carried on Minnesota's reluctance to permit acquisitions by the state's two largest companies. There is no evidence to suggest that since 1956 Minnesota policymakers have become more willing to permit such acquisitions, either. In fact, evidence suggests just the opposite. In 1973, Minnesota opposed the acquisition by Northwest Bancorporation of the Northwestern State Bank of Stillwater (an acquisition that the Fed finally approved).

[3]See, for example, Savage and Solomon 1980.

[4]For academic support, see Cournot 1963 and Saving 1970.

[5]Branching opponents were also concerned that branches of large urban banks would shift funds out of rural areas to meet the needs of their traditionally corporate customers, thereby contributing to the economic decline of rural areas. Empirical evidence, however, has not supported this argument. For an analysis and evidence on this and other arguments against branching, see Graham and Rolnick 1980.

[6]See Wallich and Varvel 1980 and the article by John H. Kareken in this *Quarterly Review*.

cial firms — among them savings and loan associations, credit unions, production credit associations, and finance companies — offer various deposits and loans quite similar to banks'. Proponents of branching contended that ignoring these firms when measuring concentration must therefore surely overestimate the market power of banks.

An empirical study of Minnesota's banking industry, proponents said, was consistent with this evaluation. That study of prices in Minnesota's supposedly highly concentrated banking industry around 1970 found no evidence that prices were not being set competitively.[7] Proponents concluded that, whatever the true degree of concentration in Minnesota's banking industry, there is no clear evidence that it is high enough to worry about.

Another counterargument to the assertion that branching would reduce competition in Minnesota's banking industry was, essentially, that the available evidence beyond Minnesota did not support the notion that branching and competition are related in any banking industry.

Based on their questionable measure of concentration, opponents of branching believed that branching increased concentration. Even if that were true, proponents argued, it would not mean, as opponents said, that branching would reduce competition. In fact, they pointed out, there is no clear evidence that concentration and competition are related in the banking industry. Many studies have looked for a relationship between the standard measure of concentration and measures of competition, usually prices and services.[8] Some have found a very weak correlation — a large increase in concentration producing a small increase in prices. But other studies have not found any relationship at all.

Studies trying to bypass the concentration question and directly connect branching and noncompetitive behavior have also failed, proponents of branching pointed out.[9] Most studies comparing prices of banking services at branch banks to those at banks without branches did not find higher prices at branch banks. Thus, according to the available evidence, whatever branching does to concentration, it does not necessarily reduce competition in the banking industry.

Proponents of branch banking also countered the noncompetitive behavior argument by pointing to a way the branching ban was actually hurting consumers of banking services. Because bank regulators required large capital investments to charter new banks and because existing banks were not allowed to branch, many Minnesota consumers did not have convenient banking facilities, they said.[10] Minnesota's urban areas had far fewer banking offices than urban areas in branching states. In 1977, for example, the Minneapolis–St. Paul standard metropolitan statistical area (SMSA) had one office for every 9,300 people while four large SMSAs in branching states (Los Angeles, San Francisco, Phoenix, and Portland, Oregon) had an average of one for every 5,300 people. Minnesota's small towns appeared underbanked too; in 1977 over 300 communities in the state did not have even one bank.[11] Proponents of branching argued that since the ban on branching had helped cause this unmet demand for banking services, allowing branching could help remedy it.[12]

1977: Limited Branching Allowed in Minnesota

Perhaps swayed by these arguments, in 1977 Minnesota policymakers relaxed the ban on branch banking somewhat. That they acted at all may be evidence that the old argument about noncompetitive behavior had lost some support and that the argument about consumers' unmet demand had gained some. But the language and the limits of the new law seem to reflect some still-strong reservations about how Minnesota consumers might be affected by banks having more freedom.

Minnesota state law still explicitly prohibits banks from branching. What policymakers did in 1977 was to amend the Detached Facilities Law so as to effectively redefine *detached facilities* as *branches*. Until

[7]Carter H. Golembe Associates 1970. Another study of Minnesota's banking industry (Dahl, Graham, and Rolnick 1977), published shortly after the limited branching law was passed, got the same results for both prices and availability of services that Golembe got for prices alone: no essential difference between affiliates of Minnesota's two large multibank holding companies and other banks.

[8]For a summary of empirical studies, see Benston 1973. For more recent evidence, see Heggestad and Mingo 1976.

[9]For a summary of these studies, see Mote 1974.

[10]See Dunne 1969, p. 46.

[11]Data sources are the Federal Deposit Insurance Corporation and the U.S. Bureau of the Census.

[12]A case for branching was also made on equity grounds. Minnesota bankers, particularly those in urban areas, were concerned that the branching ban was placing them at a competitive disadvantage with savings and loan associations, which did not operate under such a restriction. Starting in the late 1960s, both state- and federally chartered S&Ls could branch in Minnesota, and by the end of 1976 the state's 56 S&Ls had 195 branches, nearly two-thirds of which were in large urban areas.

1977 these facilities were second offices which banks could open very close to (within 3,000 feet of) their principal office, at which only very few banking functions could be performed (mainly receiving deposits and cashing checks). The 1977 amendment let banks open two instead of just one of these facilities, let banks place them much further away (within 25 miles of the main office), and let them provide virtually any service their home office did.[13] Essentially (though not explicitly), therefore, banks' detached facilities became full-service branch offices.

Obviously these changes would allow more banking offices to open in Minnesota if consumers wanted them. But also obviously the law still limited how many new offices actually could open. Again, each bank could have only two detached facilities, and they couldn't be further than 25 miles from home. Besides that, banks could not place new offices in any town with population less than 10,000 which already had a bank. And they could not merge with existing banks to obtain new offices. All of these restrictions tend to limit how large a "branch bank" could grow and so would be consistent with some concern by policymakers about noncompetitive behavior in Minnesota's banking industry.

Consumer Effects So Far

Experience in this industry since 1977 appears to indicate that consumers have benefited from banks' new, limited ability to branch.

More Places to Bank

The loosening of Minnesota's branching law has produced an avalanche of new offices. Between August 1977, when the new law went into effect, and December 1980, the number of places to bank in Minnesota increased 27 percent. Nearly all of this increase was not new banks or new automated tellers but new detached facilities: 171 banks opened 183 detached facilities in the few years since the law change. That the law change was likely responsible for the increase is clear from a simple historical comparison of bank office growth in the state to that in the nation as a whole. In the 25 years before the 1977 law change, Minnesota's percentage increase in places to bank was only a small fraction (one-seventh) of the nation's. Since the law change, however, Minnesota's bank office growth has been twice as great as the nation's.

Minnesota's expansion of banking offices since the law change has been widespread, with detached facilities being placed in 55 of the state's 87 counties. But, perhaps as policymakers intended, the chief consumer beneficiaries of the limited branching law have been residents of those areas which have been described as underbanked. Of the detached facilities opened between August 1977 and December 1980, 56 percent were placed in Minnesota's SMSAs, although these large urban areas have only about one-third of the state's banks. Another 30 percent of the "branch" offices were placed in towns that heretofore had had no bank. The rest, only 14 percent, were placed in rural towns which already had banks.

No Effects on Prices and Services

The increased convenience for Minnesota's banking consumers does not seem to have come at the expense of competition in this industry. The beleaguered standard measure of concentration did increase slightly after limited branching was allowed: between June 1977 and June 1980 the share of the state's total bank deposits held by the two large multibank holding companies edged up from 48 to 49 percent. However, the direct measures of competition — the prices and availability of services in the industry — show no evidence that lifting the branching ban led Minnesota banks to increase their prices or reduce their services in a way that suggests noncompetitive behavior.

To look for evidence of noncompetitive behavior since the branching ban was lifted, we examined data on bank prices and services reported to the Federal Reserve Bank of Minneapolis by a sample of 313 rural banks before and since that time, in 1975 and in 1980.[14] We could not, of course, just compare the levels reported by Minnesota banks in the two surveys, because factors other than the law change — including the general state of the economy — would have affected the prices and supplies of bank services. To isolate the effect of branching, therefore, we compared how bank prices and services changed in Minnesota to how they changed in two other very similar states: Iowa and Wisconsin. These two states both have rural economies quite like Minnesota's, so changes in economic factors affecting prices and services are likely to be

[13]One thing the 1977 law did not let detached facilities do is to close loans, though they could accept loan applications. This technical limitation was lifted in 1980 by another amendment to the Detached Facilities Law.

[14]Urban banks were omitted from the study because the Fed did not survey them in 1975.

similar too. Thus, if our study discovered a different change in most prices and services in Minnesota than in these states, we could be fairly confident that this was caused by the major relevant difference between the states: a change in branching law which occurred in Minnesota but not Iowa or Wisconsin. Specifically, if opponents of branching were correct about its effects, noncompetitive behavior by Minnesota banks would show up as a general pattern of bigger price increases and smaller service increases (or bigger service decreases) than those at banks in the other states.[15]

Our study did not find that pattern. As the accompanying table shows, in general, both the prices and the availability of bank services have increased in all three states between 1975 and 1980, but Minnesota's price increases have not been generally larger than the other states', and its service increases have not been generally smaller. On the table, consumers in Minnesota do look worse off than those in Iowa and Wisconsin for some prices and services: loan rates and checking account service charges rose more in Minnesota, and the proportion of banks offering automated teller services rose less. Yet consumers in Minnesota look better off than their neighbors for at least as many other prices and services: interest rates on savings and time deposits and the proportion of banks offering overdraft credit rose more in Minnesota, and service charges on insufficient funds checks and safety deposit boxes rose less.

For about a quarter of the services, the differences between changes in Minnesota and those in the other states are so small they are not statistically significant. However, even among the significant differences, no noncompetitive pattern is apparent. Some of these changes still show Minnesota consumers worse off—than Wisconsin consumers for auto installment and farm machinery loan rates and than both Iowa and Wisconsin consumers for farm operating loan rates. Much of these differences, however, is certainly unrelated to the branching change and is, in fact, due to other legal changes occurring between surveys. When differences in state usury ceilings are accounted for, all of Minnesota's "significantly" large increases in loan rates shrink considerably.[16] Besides that, for other services with significant differences, Minnesota consumers appear better off than their neighbors. The statistically large differences were in Minnesota's favor for interest rates on time deposits, service charges on insufficient funds checks and safety deposit boxes, and the proportion of banks offering overdraft credit.

Changes in Prices and Services at Rural Banks in Minnesota, Iowa, and Wisconsin From 1975 to 1980

(Based on surveys in August 1975 and November 1980)

	Minnesota	Iowa	Wisconsin
Prices (averages)			
Interest Rates (% points)			
Deposits			
Savings deposits	.42	.37	.33
Time deposits (4-year)	.16	.04◄	.08◁
Loans			
Auto installment loans	5.04	5.09	4.57◄
Farm machinery loans	6.57	6.61	5.46◄
Farm operating loans	7.67	6.56◄	5.58◄
Service Charges			
Checking accounts	$1.38	$1.22	$1.20
Nonsufficient funds checks	1.86	2.25◁	2.44◄
Safety deposit boxes	1.29	1.43	1.72◁
Services			
Availability (% point change in % of banks offering)			
Overdraft credit	11.30	5.30	3.90◁
Automated 24-hour teller	11.90	13.50	12.20
Hours Open Weekly (averages)	4.70	2.50◁	6.50◄
Number of banks in surveys	102	104	107

◁ Compared to Minnesota, difference is significant at 5% level.
◄ Compared to Minnesota, difference is significant at 1% level.

[15]Because opponents of branching argue that Minnesota's high statewide bank deposit concentration ratio represents market power for most bank services, we do not consider just one or two reported bigger price increases or smaller service increases in Minnesota as evidence of noncompetitive behavior there. To be consistent with opponents' judgment of market power, evidence of noncompetitive behavior must be a general pattern of these types of changes across all bank services.

[16]For farm loans, Minnesota's usury ceiling was lower than the other states' and also lower than market rates at the time of the Fed's first survey, so Minnesota's reported rates had to be lower than the other states' too. By the time of the second survey, all farm usury ceilings had been lifted above market rates or eliminated, so reported rates in Minnesota were much closer to those in other states. Since Minnesota's rates had climbed from an artificially low level, however, the change between surveys was greater.

For auto loans, the story is almost the reverse: Minnesota's ceiling started at about the same level as the other states', but by the time of the second survey it had been raised more. Because market rates were generally above usury ceilings, reported rates had the same relationship as ceilings: rates started at about the same level in all states, but Minnesota's ended up higher; thus the bigger increase in Minnesota.

Conclusion

Compared to the 50-year-old branch banking ban, 3½-year-old limited branching is still young. And our reported evidence on prices and services is still incomplete; it lacks data on urban banks because the Fed did not survey them in 1975. Nonetheless, the available evidence on banking in Minnesota since 1977 does seem to indicate that relaxing the branching ban has benefited consumers. In the years since the ban was lifted, many banks have used their new freedom to expand all across the state, but especially in urban areas and in small towns which had had no banks. Consumers don't seem to have had to pay the price for this increased convenience which opponents of branching long had feared: as measured by prices and services, Minnesota's banking industry appears to have remained competitive.

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