V890026

Federal Trade Commission

Denver Regional Office

Suite 2900
1405 Curtis Street
Denver, Colorado 80202-2393
(303) 844-2271

COMMISSION AUTHORIZED

February 10, 1989

The Honorable Paul D. Schauer
House of Representatives
State Capitol
200 East Colfax Avenue
Denver, Colorado 80203

Dear Mr. Schauer:

The staff of the Federal Trade Commission is pleased to submit this letter in response to your request for comments on the implications for consumer welfare of House Bill 1142, a bill to permit branch banking in Colorado after a phase-in period which ends on December 31, 1992. [1] We believe that H.B. 1142, if enacted, is likely to provide some benefits to consumers. We also believe that the legislation would not prevent small banks from competing effectively and would not increase the risk of bank failure.

<u>Interest and Experience of the Federal Trade Commission Staff</u>

The staff of the Federal Trade Commission -- upon request by federal, state, and local governmental bodies -- comments on regulatory proposals that may affect competition, consumers, or the efficiency of the economy. Under Section 5(a)(2) of the Federal Trade Commission Act, 15 U.S.C. Section 45(a)(2), the Commission does not have any authority to prevent unfair methods of competition or unfair acts or practices by banks. Accordingly, the Commission and its staff have undertaken no enforcement-related investigation of the banking industry. Although the Commission staff is familiar with competition and consumer welfare issues in other nonbanking markets, and that experience may be of some value by analogy, it is recognized that other public interest considerations outside the Commission's expertise may appropriately be considered in enacting banking

---

[1] These comments are the views of the staff of the Bureau of Economics and the Denver Regional Office of the Federal Trade Commission. They are not necessarily the views of the Commission or of any individual Commissioner. Please contact Janice Charter of the Denver Regional Office at 844-2271 if you have any questions.

legislation. We are not suggesting, for example, that audit and other regulatory safeguards should be relaxed in any fashion. The comments below are based for the most part on articles and materials prepared by individuals not affiliated with the Commission staff.

Description of H.B. 1142

The bill would amend the "Colorado Banking Code of 1957," Colorado Revised Statutes § 11-6-101 (1987 Repl. Vol.) to permit unrestricted branch banking after a four-year transition period during which certain geographical and numerical restrictions would be in effect.

Consumers are likely to benefit from the removal of restrictions on branch banking

A number of studies, some of which are summarized below, suggest that the performance of banks, in terms of consumer prices and services, is better in states that permit branching than in states that do not (referred to below as unit-banking states). Some indications of improved performance are lower loan interest rates and checking service charges, higher deposit interest rates, greater availability of loans (higher loan-to-asset ratios), and reduced personnel expenses.

One study found that unit banks, or banks with a single location, earned 17.5 to 23 percent higher rates of return in unit-banking states than in branching states, which the author attributed to the ability of banks in unit-banking states to assess higher service charges and loan interest rates. [2] A study that examined the differences in performance of unit banks in unit-banking states, restricted-branching states, and unrestricted-branching states found that unit banks in unrestricted-branching states paid higher interest rates on deposits and earned lower rates of return on assets than unit banks in unit-banking states. Unit banks in limited-branching states also earned a lower rate of return on assets, charged lower interest rates on loans, charged lower service fees on demand deposits, and paid higher interest rates on deposits than unit banks in unit banking states. [3] Thus, these studies

---

[2] Flannery, Mark J., "The Social Costs of Unit Banking Restrictions," Journal of Monetary Economics, March 1984, pp. 237-249.

[3] Savage, Donald T., and Rhoades, Stephen A., "The Effect of Branch Banking on Pricing, Profits, and Efficiency of Unit Banks," Proceedings of a Conference on Bank Structure and

suggest that banks in states that do not permit branch banking assess higher service fees, charge higher interest rates on loans, and pay lower interest rates on deposits than banks in states that allow more competition.

California has had statewide branching since 1909. A report of the Governor's Banking Study Committee on the Future of Banking in California discussed the impact of branch banking on California consumers:

> The dominant position of the branch banking system in the State has led to a rapid proliferation of total banking offices, even while the number of unit banks in the State was declining for a time. It is the opinion of this Committee that competitive pressures which exist in ten major markets have worked their way through to most California communities of whatever size and to the benefit of most California borrowers. [4]

Other studies, while not specifically directed at the branch banking issue, have looked at the effect of increased competition on bank performance. One of these compared the pre-entry and post-entry performance of banks in one-, two-, and three-bank markets in Texas and Oklahoma. Before entry, the banks studied had lower than average ratios of loans to assets and time deposits to total deposits. A low loan-to-asset ratio may indicate that a bank has not been aggressive in meeting the credit needs of its community, preferring instead to put more of its funds into investments such as government securities. A bank with a low ratio of time deposits to total deposits is paying out less overall to its depositors than other banks, indicating that more of its deposits are held in accounts that pay either no interest or lower rates of interest. After competitive entry, both ratios rose to average levels, indicating an increased emphasis on business and consumer loans, as opposed to investments. Interest paid on deposits also went up, an additional benefit to consumers. [5]

Competition, Chicago: Federal Reserve Bank of Chicago, 1979, pp. 187-196.

[4] Governor of the State of California, Report of the Governor's Banking Study Committee on the Future of Banking in California, January 1965, p. 70.

[5] Fraser, Donald R., and Rose, Peter S., "Bank Entry and Bank Performance," Journal of Finance, March 1972, pp. 65-78. This is not meant to suggest that all Oklahoma and Texas banks in one-, two-, and three-bank markets had lower than average ratios

We also believe that both individual and business consumers are likely to benefit from the increased convenience offered by branch banking. Currently, consumers must select a new bank when they move from one community to another. Removing these restrictions would allow many bank customers who move merely to transfer their records to another branch in their new community.

Branch banking may also allow firms or organizations with operations in many communities to simplify their banking relationships and reduce cash management costs. Currently, firms, especially chain stores, may find it necessary to open an account at a different bank for each community in which they operate. The absence of a single bank may impose significant cash management expenses on these firms, a burden that would be relieved by branch banking. [6]

The possible effect of branch banking on the likelihood of bank failure

One of the most frequently cited criticisms of unrestricted branch banking is that it will destroy small community banks. A bank failure may impose significant costs on consumers. Long established banking relationships are interrupted, and some uninsured deposits may be lost. From a consumer standpoint, therefore, it is important to examine whether branch banking is likely to lead to bank failure.

Loans constitute the majority of assets on the balance sheet of almost all banks. For both economic and legal reasons, a bank lends mostly to businesses and individuals located in communities

---

of loans to assets and time deposits to total deposits, only that for banks with low ratios, competition caused those ratios to rise. Although the competition that occurred did not come from branch banking, the effects of greater competition are illustrative. Similar results were reported in Chandross, Robert H., "The Impact of New Bank Entry on Unit Banks in One Bank Towns," Journal of Bank Research, Autumn 1971, pp. 22-30, and McCall, Alan S., and Peterson, Manfred O., "The Impact of De Novo Commercial Bank Entry," Compendium of Issues Relating to Branching by Financial Institutions, Washington, D.C.: U.S. Senate Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs, October 1976, pp. 499-521.

6 Becker, Michael, Horwitz, Steve, and O'Quinn, Robert, "Interstate Banking: Toward a Competitive Financial System," Citizens for a Sound Economy Issue Alert, No. 18, September 16, 1987, pp. 7-8.

where it maintains offices. Thus, where local economies are not well diversified, restrictions against branch banking leave banks vulnerable to failure from local economic downturns. This could be particularly important in a state like Colorado, where local economies may be heavily dependent on single industries such as skiing, farming, or tourism.

Various studies show that since 1933, bank failure rates have been lower in states which permit unrestricted branching than in states that do not. One study found that "evidence from as far back as the 1920s and 1930s suggests that failure rates were lower among multi-office organizations than unit banks." [7] A 1980 Treasury Department study concluded:

> Broader intrastate branching authority may reduce the threat of bank failures and increase the continuity and quality of service to local communities. [8]

The Treasury study confirmed similar findings of the U.S. Senate Subcommittee on Financial Institutions. [9] This evidence indicates that Colorado banks may be less rather than more susceptible to economic disturbances if branching is allowed. We have found no evidence that branching contributes to an increase in the rate of bank failure.

We do not mean to suggest that the profits of banks experiencing competitive pressures from the removal of branching restrictions would remain at their previous levels. If branching results in an increase in the number of banks in a local market, the profits of incumbent banks would probably decline. This would not necessarily result in bank failure, however, if the incumbent banks were previously experiencing above average profits. As mentioned above, a number of studies point to the existence of above average profits in areas where there is little competition. One such study looked at the effect of entry

---

[7] Eisenbeis, Robert A., "Interstate Banking's Impact upon Financial System Risk," Economic Review, Atlanta: Federal Reserve Bank of Atlanta, March 1985.

[8] US, Department of the Treasury, Geographic Restrictions on Commercial Banking in the United States: The Report of the President, January 1981.

[9] Gilbert, Gary C., "Branch Banking and the Safety and Soundness of Commercial Banks," Compendium of Issues Relating to Branching by Financial Institutions, Washington, D.C.: U.S. Senate Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs, October 1976.

in 98 previously one-bank towns. The study found that for the three years before entry, banks earned significantly above average profits. In the three years following entry, bank earnings fell significantly, but not below the average for all banks in the same state. [10]

It is possible, however, that the removal of branching restrictions might reduce the returns of less-efficient banks below a "normal" rate. While these banks may still earn positive profits, the returns would be lower than those attained in other industries. These banks might then be absorbed by more efficient banks, including new entrants. Acquiring a currently operating bank with an established asset base is typically more efficient for an entrant than de novo entry. Alternatively, banks may respond to increased competition by improving their performance through changes in the quality of their products, e.g., by offering more personalized service. This behavior may explain the inability of New York City banks to achieve any significant degree of penetration in upstate New York markets after the removal of branch banking restrictions in 1970. In analyzing the New York experience, one commentator has stated:

> [T]here is virtually no evidence that small banking organizations cannot compete effectively head-to-head with larger banks...[T]he attempt by New York banks to move in upstate communities provides but one recent example where local banks were able to perform very well against larger competitors. These local bankers showed formidable strengths in their ability to serve their communities where they were encouraged to do so [by statewide branching]. The interest that they paid on deposits rose, the interest charged on loans fell, and the perks that the local bankers were able to take for themselves were reduced. But profit margins in many cases were not significantly affected, once these local bankers began to compete. [11]

---

[10] Chandross, Robert H., "The Impact of New Bank Entry on Unit Banks in One Bank Towns," Journal of Bank Research, Autumn 1971, pp. 22-30.

[11] Interstate Banking: How much, How fast?, The Heritage Lectures 45, March 23, 1985, p. 7. See also, Frank B. King, "Upstate New York: Tough Market for City Banks," Economic Review, Atlanta: Federal Reserve Bank of Atlanta, June-July 1985, pp. 30-34.

Conclusion

We believe that an easing of restrictions on branch banking is likely to benefit consumers in terms of greater convenience, higher interest rates on deposits and lower interest rates on loans. We also believe that a loosening of branch banking restrictions would not render small banks unable to compete, nor will it increase the risk of bank failure.

Please get back in touch if you have any questions concerning this letter, or if we can be of assistance in any other way.

Sincerely,

Claude C. Wild III
Director
Denver Regional Office