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The branch banking boom in Illinois: A byproduct of restrictive branching laws

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What's behind the boom in bank branches across Illinois, particularly in Chicago? The authors explore the history of branch banking within the state and across the nation to help explain this recent trend and discuss its future implications.

Bank branches, like coffee shops, have become a ubiquitous part of the American landscape. In Chicago's commercial banking district, twelve banking offices now dot LaSalle Street between the Chicago River and the Chicago Fed, more than double the five coffee shops along this half-mile stretch.[1]

As of June 30, 2006, Illinois boasted 4,349 banking offices, two-thirds more than in 1994.[2] This aggregate state growth is unusual, since the number of banking offices nationwide grew only 23% between 1994 and 2006. Politicians in Illinois have begun to take notice. The City of Chicago amended Chapter 17-3-0504-I of its zoning code in 2004 to require banks to apply for special use permits to build new banking offices in certain areas, and several Chicago suburbs have enacted similar restrictions. In this *Chicago Fed Letter*, we explore the reasons behind the recent bank branching boom and discuss its implications.

> As of June 30, 2006, Illinois boasted 4,349 bank branches, 66% more than in 1994. This statewide growth is extraordinary; the number of branches nationwide grew just 23% between 1994 and 2006.

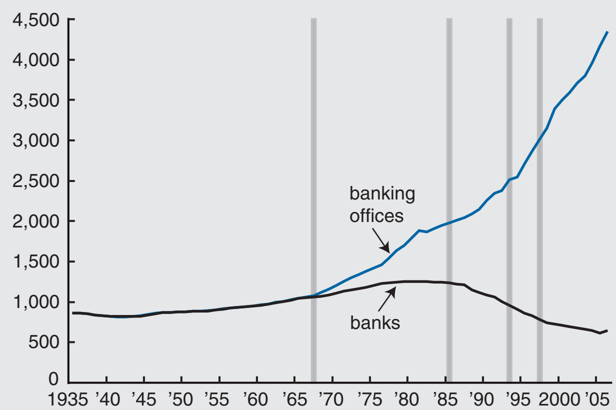
The history of branch banking in Illinois

In large part, the current trend in banking office growth is a product of Illinois' banking history. Restrictive bank branching laws in Illinois suppressed expansion for decades. With the relaxation of these restrictions, the number of banking offices has increased sharply in the last dozen years or so.

The state of Illinois was one of the most restrictive bank branching states in the country. It was what is known as a "unit banking" state in which each bank was allowed to operate only one office.[3] The state constitution of 1870 prohibited branch banking, and that prohibition remained in place until the mid-1960s. The first revision, adopted in 1967, allowed a bank to operate one additional drive-up facility within 1,500 feet of the unit bank. By 1985 banks were allowed to have up to five offices, two of which could be in other counties if they were located no more than ten miles from the head office. Finally, in 1993, the limitations on interstate branching were completely removed; for the first time Illinois banks were allowed to branch freely *within* the state. These laws applied both to national banks chartered by the federal government and to state banks chartered by the individual state regulatory agencies.[4]

Until 1994, federal law prohibited bank branching *across* state lines. The Riegle–Neal Interstate Banking and Branching Efficiency Act (IBBEA) removed these restrictions when enacted in 1994. IBBEA allowed states to opt in to interstate branching and, if they chose to do so, determine how restrictive statewide provisions on interstate branching could be. Illinois opted in to IBBEA in 1997 and, as of 2004, allows nearly unrestricted interstate branching.

1. Banks and banking offices in Illinois, 1935–2006



Notes: Vertical lines represent years of branch banking deregulation. Banking offices include both main offices (banks) plus “other” offices (branches) of state and national banks.

Sources: Authors’ calculations based on data from the Federal Deposit Insurance Corporation and Federal Reserve System.

The explosion of bank branches

In addition to suppressing banking office growth, Illinois’ once restrictive branching environment also protected small banks, allowing a relatively large number of them to operate in the state. In 1994, Illinois had 994 banks (0.84 banks per 10,000 residents) with an average of $296 million in assets (in 2006 dollars). Nationwide (excluding Illinois), each state had on average 207 banks (0.60 banks per 10,000 residents) with $671 million in assets (in 2006 dollars). Today, though there are fewer banks nationwide, Illinois is still home to more small banks than other states, on average. As of June 2006, Illinois had 650 banks (0.54 banks per 10,000 residents) with $545 million in assets, while other states had on average 145 banks (0.43 banks per 10,000 residents) with $1,858 million in assets.

Because this environment allowed many small banks to exist, Illinois’ banking markets were among the least concentrated in the country (measured at both the city level and state level), and this trend continues today. Using a common measure of market concentration, Illinois was less concentrated than 47 states in 1994.[5] Back then, Chicago was the third least concentrated metropolitan area out of 369 metropolitan areas in the U.S. Interestingly, the relaxation of branching restrictions in Illinois did not significantly change the concentration of its banking markets. In 2006, Illinois was less concentrated than 42 states, while Chicago was the sixth least concentrated metropolitan area out of 369 metropolitan areas in the U.S.

Figure 1 shows the change in the total number of banks versus the total number of banking offices from 1935 through 2006; the vertical lines represent major regulatory changes in Illinois. The total number of banks was fairly constant until 1967, and nearly all of these were unit banks. Banks were able to expand their branch networks, to a limited extent, by acquiring existing banks. As banks merged, the number of banks operating in Illinois grew more slowly and, after 1980, began to fall. In 1988, legal changes steepened this decline; Illinois began to allow bank holding companies with more than one bank to merge their banks without giving up any of the branches.

Figure 1 also highlights the banking office growth. When intrastate branching restrictions were relaxed, branch expansion boomed. Many institutions began to compete for market share, as larger out-of-state banks began acquiring and building banking office networks in Illinois and existing Illinois banks opened additional banking offices.[6] The combination of large out-of-state banks and small Illinois banks fueled the banking office growth, which appears more dramatic when compared with national averages. In 1967, each state in the U.S. had on average 1.86 banking offices per 10,000 residents, while Illinois had only 0.99. Only one state (Florida) had fewer banking offices per capita. By 1994, Illinois had 2.20 banking offices per 10,000 residents. This rose to 3.39 banking offices per 10,000 residents by 2006, surpassing the national average of 3.21.

These two observations—that Illinois’ banking markets are relatively unconcentrated and that Illinois has experienced higher branch growth—are related. Figure 2 shows this pattern: The trend line illustrates a negative relationship between branch growth and market concentration. This figure plots the percentage growth in banking offices with our measure of market concentration for the largest 15 cities. Chicago is located in the top left-hand corner of the figure, above the line; of these 15 cities, it has experienced the highest branch growth and remains the most competitive market. Interestingly, five of the seven cities plotted above the trend line are located in states that were once unit banking states.

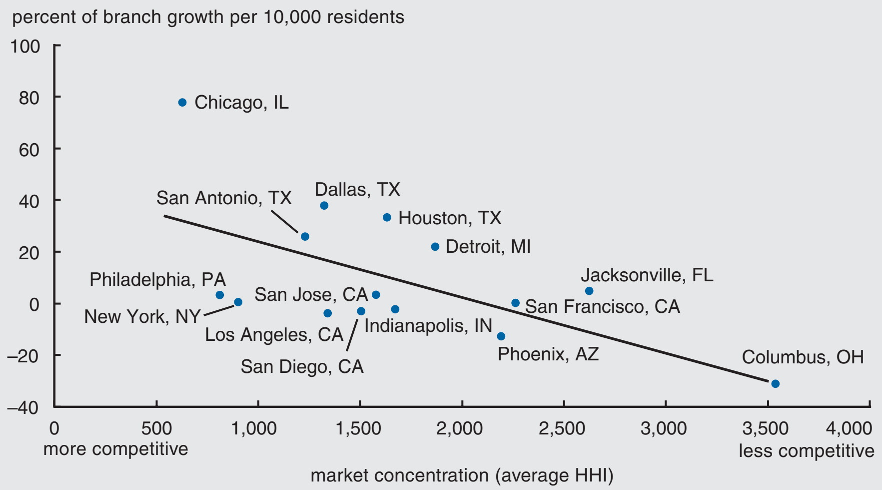
The political economy of bank branching

There are a number of reasons why Illinois and many other states enacted restrictive branching regulations. One objective was to limit the power of banks by constraining their size. Opponents of branch banking thought that if banks became too large they would exert excessive political and economic influence.[7] Residents were concerned that if big banks were allowed to branch into small towns, they would siphon deposits out of these towns and use them to make loans to larger clients in financial centers.[8] As a result, small businesses and local communities would be without the capital they needed to thrive. Branching restrictions were also intended to make banking safer by shielding banks from excessive competition[9] and to protect and enhance state banking regulation fees, which made up a large percentage of many states’ revenues.[10]

The banks that were the beneficiaries of these regulations were naturally strong supporters of branching restrictions. Bankers in small towns, in particular, lobbied effectively against branch banking, motivated in part by their desire to insulate themselves from competition by larger out-of-state banks.[11]

Experience has shown that branch banking did not merit many of these early concerns. When states introduced statewide branching, banks’ loan losses and

2. Market concentration and branch growth in largest 15 cities, 1995–2006



Notes: Concentrations are measured using the Herfindahl-Hirschman Index (HHI). For further details, see www.usdoj.gov/atr/public/testimony/hhi.htm. The HHI increases, indicating higher concentration (or less competition), both as the number of firms in the market decreases and as the disparity in size between those firms increases.

Sources: Authors' calculations based on data from the Federal Deposit Insurance Corporation and Federal Reserve System.

noninterest expenses decreased significantly, and these savings were largely passed along to consumers in the form of lower loan rates.[12] Branching has been shown also to increase the stability of the banking system by reducing bank failures through diversifying banks' customer base and increasing competition, forcing less efficient banks to exit.[13]

Deregulation: What changed?

The preceding discussion highlights how regulation of bank branching involved competition among several parties. Disparate interests among the various parties provided an environment that allowed continuance of branching restrictions as barriers to entry, meant to protect the competitive position of small banks. These restrictions did, for a while, enhance small banks' profits. However, a number of events undermined the value of supporting these restrictions on branching.[14] Lobbies for small banks in Illinois had the political clout for many years to defeat attempts to liberalize the state's branching laws.[15] Significant changes to the branching laws finally surfaced in the 1980s when the benefits of local monopolies were being challenged by technological advances, such as automatic teller machines (ATMs) and telephone banking.[16] At the same time, high interest rates and increased competition from nonbanks made it more difficult for many banks to maintain profitability. As a result, some faltering banks desired to merge with larger banks but were unable to do so because of branching restrictions.[17] As technological and economic factors threatened the status quo, the net burden of maintaining regulatory restrictions increased until one-time opponents began to support liberalization of branching laws.[18]

One of the most significant changes to branching laws, however, sprang from external forces. In 1987, a court ruling in Mississippi allowed national banks to branch in Illinois and 20 other states.[19] The ruling did not apply to state-chartered banks. Illinois politicians were thus concerned that the state's current branching restrictions would put state-chartered banks at a disadvantage relative to federally chartered banks. As a result, in 1993, Illinois changed its laws to allow all banks to branch within the state without restriction.

Conclusion

Will this expansive branching trend in Illinois, particularly in Chicago, continue, or will it fall in line with national branch growth rates? This question seems appropriate in light of consumers' rapid adoption of online banking and electronic payments. Recent contradictory announcements by Chicago banks give no clear indication. Several banks plan to build additional branches in Chicago in hopes of generating new accounts; estimates suggest that more than 90% of new transaction accounts in the U.S. are opened at physical branches.[20]

Conversely, the market may be posed for a slowdown in branch growth, as several financial institutions announced plans to close underperforming branches in the Chicago area.[21] As the Illinois banking market becomes more saturated, banks may decide they can no longer maintain the current number of banking offices.

While the future growth of bank branching in Illinois is unclear, there is one lesson: Though an overarching objective of the original branching restrictions was to prevent large out-of-state banks from competing with smaller banks, ironically, these restrictions have contributed to a great deal more local competition in the long run.

[1] Branch banking is defined as a single legal bank entity operating more than one banking office. See C. E. Cagle, 1941, "Branch, chain, and group banking," in *Banking Studies*, Federal Reserve Board, Baltimore, MD: Waverly Press, p. 113. In our article, banking offices include both

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main offices (banks) plus "other" offices (branches) of state and national banks.

[2] Branching statistics in this article are calculated by the authors using Federal Deposit Insurance Corporation (FDIC) data.

[3] Unit banking states were: Colorado, Arkansas, Florida, Illinois, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, North Dakota, Oklahoma, Texas, Wisconsin, and West Virginia; see Kevin J. Stiroh and Philip E. Strahan, 2003, "Competitive dynamics of deregulation: Evidence from U.S. banking," *Journal of Money, Credit, and Banking*, Vol. 35, No. 5, October, pp. 801–828.

[4] Bank branching is governed by both federal and state level laws; laws at either level may affect branching across state lines (*inter*state branching) and/or branching within a state (*intra*state branching). Federal law allows national banks to branch wherever state banks are allowed to branch, but does not grant national banks any additional branching powers.

[5] Concentration is measured using the Herfindahl-Hirschman Index (HHI), calculated from Federal Reserve and FDIC bank data. For further details, see www.usdoj.gov/atr/public/testimony/hhi.htm.

[6] Steven Reider, president of Bancography states: "In any market, the bank with the largest network gains a disproportionate share of deposits." See Rob Garver, 2007, "Why branch growth will maintain its momentum," *American Banker*, January 16.

[7] George Kaufman, 1985, "Banking without the barriers," *Chicago Tribune*, January 15.

[8] Eugene Nelson White, 1983, *The Regulation and Reform of the American Banking System, 1900–1929*, Princeton, NJ: Princeton University Press, pp. 196–197.

[9] David A. Alhadeff, 1962, "A reconsideration of restrictions on bank entry," *Quarterly Journal of Economics*, Vol. 76, No. 2, May, pp. 246–263.

[10] Randall S. Kroszner and Philip E. Strahan, 1999, "What drives deregulation? Economics and politics of the relaxation of bank branching restrictions," *Quarterly Journal of Economics*, Vol. 114, No. 4, pp. 1437–1467.

[11] Robert A. Bennett, 1981, "Turnabout by Chicago banks," *New York Times*, August 31, Section D; and Steven Horwitz and George A. Selgin, 1987, "Interstate banking: The reform that won't go away," Policy Studies, Policy Analysis, Cato Institute, No. 97, December 15.

[12] Jith Jayaratne and Philip E. Strahan, 1997, "The benefits of branching deregulation," *Economic Policy Review*, Federal Reserve Bank of New York, Vol. 3, No. 4, December, pp. 13–29.

[13] Mark Carlson and Kris James Mitchener, 2005, "Branch banking, bank competition, and financial stability," Finance and Economics Discussion Series, Board of Governors of the Federal Reserve Board, working paper, No. 2005-20, March.

[14] Edward J. Kane, 1996, "De jure interstate banking: Why only now?," *Journal of Money, Credit, and Banking*, Vol. 28, No. 2, May, pp. 141–161.

[15] Bennett (1981); and William R. Bryan, 1975, "To branch or not to branch, an issue that finds Illinois bankers divided," *Illinois Issues*, December, Vol. 1, No. 12, pp. 364–366.

[16] Kroszner and Strahan (1999).

[17] Note, however, a provision in the 1982 Garn–St Germain Act authorized federal banking agencies to arrange interstate acquisitions for failed banks with total assets of $500 million or more.

[18] Kane (1996).

[19] Department of Banking and Consumer Finance v. Clarke, 809 F.2d 266 (5th Cir.) cert. denied, 483 U.S. 1010 (1987).

[20] Hal Hopson, 2006, "De novo branch performance: Portfolios and places," presentation at BAI Retail Delivery Conference and Expo, Las Vegas, NV, November 16.

[21] Becky Yerak, 2006, "Washington Mutual steps back," *Chicago Tribune*, September 8, p. 3; Steve Daniels, 2006, "Banks begin to retrench," *Crain's Chicago Business*, December 18; and Becky Yerak, 2007, "Chase plans growth while others fight cuts," *Chicago Tribune*, February 14.