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## THE BRANCH BANKING QUESTION

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## THE BRANCH BANKING QUESTION\*1/

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### I. The Role of Banking in the Development of the Community

It is well to keep in mind that a discussion of banking policy is not a discussion about any old industry or institution. A bank is not a hamburger stand and if one is to understand what the proper banking structure should be, one must first understand the very special characteristics of a bank and the important role which it plays in the community; that is, how a bank differs from any old firm. This may seem obvious to most or even all of the people here today. However, to this day, and as you might expect I will not use this argument, banks have been judged in their performance in terms of how well they perform like all other firms. Today my discussion of banking performance will not be conducted as though banks were just an ordinary firm, but rather in terms of the special characteristics which put banks in a crucial role for the well-being and development of any community.

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\*Presented to the Joint Subcommittee on Banking, State of Minnesota, April 9, 1970.

1/ A staff paper is not necessarily reviewed within the department and the views expressed are solely those of the author and not attributed to the University of Minnesota.

Banks are a financial institution and as such they must be judged by how well they transfer the surplus resources of the community into realized investment projects. They are not just any financial institution, because in many parts of Minnesota they are the only financial institution available to fill this need. If they are unsuccessful in their job, the entire community in which they exist pays the cost, and unlike other firms, the costs are measured in jobs not available and income not earned. Thus when the hamburger stand does not do a good job, it goes out of business, you eat your hamburgers elsewhere, but when the local bank does not perform well, the new jobs for the young adults will not be there for them, the resources of the community will not be used, the community will not develop as it should.

This is the issue here today, the cost in jobs, and income not available for any particular banking structure. There is a cost for any system and the real choice depends on which cost you want to bear. And our choice of a particular banking structure should depend not on whether a certain system exists or not, but rather on what system will best serve the citizens of Minnesota.

Before proceeding to a presentation of the relevant Minnesota banking data, it might be well to review, briefly, the arguments and evidence used in the banking debate up to the present time.

## II. The Tradition Banking Argument

Traditionally, the argument about banking performance has revolved around whether a particular structure is more or less competitive than another structure. The measure of competition used is the number of banks in any area, the freedom of entry of any system to new banks, and the cost efficiency with which any system operates. Let me take each of these issues in turn.

### A. The Number of Banks in an Area

If one uses the total number of banks in any area to measure the degree of competition between branch and unit banking systems then except for the very large cities over 500,000 in population, there are about as many branch banks as unit banks. In cities over 500,000 there are more unit than branch banks. This fact is brought out clearly in Tables I and II below.<sup>1/</sup>

However, this argument is a little deceptive because the number of banks can only be evaluated in terms of a particular market area and it is not clear that relevant market is the same for branch and unit banks. The following example might help to clarify this point. Suppose we

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<sup>1/</sup> See Bernard Shull and Paul Horvitz, "Branch Banking and the Structure of Competition," The National Banking Review, March, 1964, Tables 20 and 21, p. 329.

TABLE I  
 Average Number of Different Banks  
 Per Standard Metropolitan Area, June 1962,  
 by Type of Branching Law\*

Population Size of Metropolitan Area	States with Statewide Branching	States with Limited Branching	Unit Banking States	United States
10,000 - 99,999	4.75	6.40	6.23	6.00
100,000 - 499,999	7.38	10.35	14.97	10.99
500,000 - 999,999	12.38	13.07	38.83	18.21
1,000,000 and over	27.60	47.17	105.67	58.17
All Metropolitan Areas	10.22	15.07	24.23	16.74

\*Source: Shull and Horvitz, "Branch Banking and the Structure of Competition," The National Banking Review, 1964, p. 329.

TABLE II

Number of Different Banks and Number of  
Standard Metropolitan Areas,  
June 1962, by Type of Branching Law\*

Population Size of Metropolitan Area	States with Statewide Branching		States with Limited Branching		Unit Banking States		United States	
	No. of Banks	No. of Areas	No. of Banks	No. of Areas	No. of Banks	No. of Areas	No. of Banks	No. of Areas
50,000 - 99,999	19	4	32	5	81	13	132	22
100,000 - 499,999	214	29	683	66	554	37	1451	132
500,000 - 999,999	99	8	196	15	233	6	528	29
1,000,000 and over	138	5	566	12	634	6	1338	23
Total	470	46	1477	98	1502	62	3449	206

\*Source: Ibid., p. 329.



consider a state where there is only one grocery store in every town and we compare this state with one where there are only two grocery firms with a chain store in every town. In which case will there be more competition. In the one case, each grocery has a virtual monopoly of food service for its town, while the two chain stores might very well compete statewide. This example is not as far-fetched as it sounds, for in 28 out of the 87 counties in Minnesota there are 5 or less banks.<sup>1/</sup> The problem of banks having monopoly control of financial services is very serious in a large part of Minnesota.

#### B. Bank Entry

The issue of bank entry also is one that can be deceptive. If you measure bank entry by the number of new banks, then more new banks are created in unit banking states than in branch banking states. However, if you measure entry by the number of new offices, then the number of new offices in branching states greatly exceeds the number in unit banking states. Table III, using the number of bank office creations between 1953 and 1962 for the United States as a whole, shows that there was a 7.6% increase in the number of bank offices

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<sup>1/</sup>This is as of December 1968.

TABLE III

Changes in the Banking Structure, 1953-1962,  
by Type of Branching Law\*  
(Percent)

State Classification	Change in Number of Banks	Change in Number of Branches	Change in Number of Banking Offices	Ratio of New Banks to Number of Banks 1953	Ratio of Mergers to Number of Banks 1962	Ratio of New Banks in Mergers
Statewide Branching States	-25.3	+109.5	+58.5	12.1	36.6	33.1
Limited Branching States	-12.4	+139.7	+34.9	4.5	16.5	27.6
Unit Banking States	+ 7.6	--	+ 7.6	10.3	1.8	563.8
All States	- 4.6	+126.5	+30.3	7.9	11.8	66.7

\*Source: Ibid., p. 315.

in unit banking states compared with a 58.5% increase in state-wide branching states.<sup>1/</sup>

The reason for this vast difference is rather straight forward. Given the risk of failure to any new business, the Federal Reserve Board and state chartering organizations act very conservatively, and rightly so, in granting new bank charters. However, given that a new branch is a small part of any branching system, the probability that an unsuccessful new branch will cause the entire system to fail is very small.

#### C. Cost Efficiency Argument

I will not say very much about this particular issue. The results so far comparing the cost of operation of branch systems to unit systems are inconclusive. In general, the problem is that data on branching systems by individual office is very difficult to obtain. The result is that the comparisons tend to be in terms of a unit bank compared to a branch system which is obviously not the relevant comparison.

### III. Evidence in the '60's--Minnesota Banking Data

So far the discussion has run in terms of the traditional arguments, which has not as yet given us a great deal of insight into the problem. At this point, it might be useful

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<sup>1/</sup>It should be pointed out that the loss in bank numbers in branching states is accounted for by mergers and not by bank failures.

to describe the performance of Minnesota banks in the last ten years. For this purpose, let us look at some particularly relevant statistics. In terms of the criteria, I set out initially, the percentage of total deposits used for loans is particularly useful. Remember I said that a bank should be judged by how much of its funds are being used to encourage realized investment. In addition, in order to evaluate the impact of the loan policy of various categories of banks, it is also useful to know the distribution of loans between various types.

Table IV below presents the loan to deposit ratios alone with the percentage breakdowns of five types of loans: loans for purchases of land and real estate, loans to other financial institutions, loans to farmers, loans to business and corporations, and consumer loans to individuals. In addition, to compare the rural-urban breakdown, I determined the average rates for the highest and lowest 10% of the counties ranked by total number of deposits.

The results of this can be summarized rather quickly. The average loan to deposit ratio for all Minnesota banks from 1960 to 1964 is 47% and moves to 51% in 1968. If all banks performed alike, then we should observe no significant difference between the loan-deposit ratio of the highest and the lowest 10%. However, that is not what we observe. The lowest

TABLE IV: Loan to Deposits and Loan Categories in Percent, All Minnesota Banks and Highest and Lowest 10%, December 1960, 1964 and 1968\* 1/ 2/

		Loan Categories as Percent of Total						Personal Consumer
		Loans to Deposits	Real Estate	Financial Business	Farm	Industrial		
1960	All Banks	47.08	35.85	1.08	31.81	11.91	18.38	
	Lowest 10%	43.09	33.21	2.68	32.55	10.74	19.85	
	Highest 10%	51.74	35.67	4.26	10.46	23.64	23.93	
1964	All Banks	47.49	34.73	1.62	30.05	13.37	19.27	
	Lowest 10%	44.32	34.16	4.15	31.58	10.03	19.61	
	Highest 10%	52.53	35.49	6.08	8.32	24.43	23.93	
1968	All Banks	50.97	34.30	1.45	27.32	15.29	20.74	
	Lowest 10%	47.63	29.90	2.08	33.53	12.14	20.49	
	Highest 10%	57.83	35.31	5.19	7.58	25.55	24.74	

\* Source: December Call Reports

1/ The Highest and Lowest 10% refer to counties ranked by total deposits.

2/ The averages are by counties since the totals by banks are not available.

10% are consistently below the highest 10%, where the difference between them averages somewhat over 9% moving from 8-3/4% in 1960 to 10.20% in 1968. There is something different between the performance of rural and urban banks.

As a means of determining what this is, let us consider the loan portfolio breakdowns of the banks for the same period. We observe that real estate loans make up about one-third of total loans and this is approximately true for both the highest and lowest 10%--remember that these represent the rural and urban extremes. The loans to other financial institutions make up a small percentage of total loans, somewhat below 2 per cent on the average. However, the per cent of the urban banks is consistently above the rural banks.

Once we get to farm loans, the difference in portfolios becomes clear. There is a consistent difference between the per cent of farm loans between the rural and urban banks, somewhat over 20%. In addition, however, the per cent of farm loans on average falls from something under 32% to 27-1/2% over the decade. This fall is entirely accounted for by a drop in the participation of urban banks in farm loans. This fact reflects two things. Over the period of the 1960's banks have been having stiff competition from other agricultural credit institutions and have lost a percentage of the agricultural credit market. Further, the city correspondent banks have not done their part to participate in agricultural loans.

If you look at the percentage of farm loans by the Twin City banks over the '60's, then it is consistently less than one per cent and falls over the period. This is an indication that the correspondent system is providing a flow of funds to the urban correspondent banks but not a reverse flow in terms of agricultural participation loans.

The last two types of loans gives just the result one would expect. Whereas in farm loans the rural banks were heavily committed, the urban banks have a much higher commitment to industrial loans and slightly higher, a four per cent higher, participation in the individual type of loan.

Our reason for investigating the loan portfolios was to provide an explanation of the difference between the loan to deposit ratio of the urban and rural banks. How then does the difference in their loan portfolios help us explain the difference in their total loan behavior? If you look at the portfolio of the rural banks, you will notice that almost all their loans are tied to agriculture. The real estate loans are mostly agricultural real estate; the individuals they are lending to are farmers or related to farming. Thus, virtually their entire loan portfolio is tied to the well being of a single area, agriculture. If something should happen to the particular type of agriculture that the rural bank is tied to, then we could expect a high rate of default in loans that year. In other words, because rural

banks tend to have a less diversified portfolio than urban banks, the risk which a rural bank faces is greater than the equivalent city bank. Given this greater risk faced by a rural bank, it is rational to have a smaller percentage of total assets in loans.

However, the fact that it is rational for the rural unit bank to have a lower loan-deposit ratio does not prevent the adverse effects from happening anyway. Those extra loans which might be made could provide a lot of jobs for a lot of people and a lot of income for clothing and houses and cars and schools. In short, the effects will be felt just the same.

Now that we have gotten to the problem, that the rural banks are not performing as well as the urban banks let us compare the performance of different types of systems in terms of their loan behavior. The most relevant comparisons would be between a branch system and a unit system operating in Minnesota. Unfortunately, that option is not available to us. We can, however, infer what the effects of a branching system on Minnesota would be by comparing the loan performance of the holding company affiliate banks with the remaining units banks and also by comparing the performance of unit banks and branch offices in one and two bank towns in other states.

In Table V, using available data, I compute the average loan to deposit ratios of holding company affiliates and nonholding company unit banks. There is a 5% difference in



TABLE V

The Loan to Deposit Ratio of Holding Company  
 Affiliate Banks and Non-Holding Company  
 Affiliates, 1968, in Minnesota\*

	<u>All Commercial</u>	<u>Holding Affiliates</u>	<u>All Other Banks</u>
Total Loans to Total Deposits by Bank	48.10	51.82	47.39
Total Loans to Total Deposits Aggregate	55.93	58.41	52.23
Total Loans (in mil. of \$)	4,774	2,984	1,790
Total Deposits	8,536	5,109	3,427

\*Source: Ninth District Banking Data, 1969.

the loan ratios of holding company affiliates and other unit banks. The holding company affiliates seem to be significantly out performing the other unit banks. Before drawing further conclusions from this, let us consider whether or not the holding company affiliates are acting as we would expect branch offices to.

Table VI is taken from an unpublished study of branch office and unit bank comparisons in one and two bank California towns. Observing the statistics thus presented, that the branch offices consistently have higher loan to deposit ratios both when they are the only bank in town and competing with another branch office or unit banks, it is hard to escape the conclusion that the branch offices will out perform a unit bank both when they are the only bank facility or when there are two bank facilities in a town. The fact that both the holding company affiliates and branch offices out perform equivalent unit banks is a definite indication that the legalization of branch banking in Minnesota would improve the performance of the banking system here. However, a real question arises at this point. What forces are operating in a holding company and branch banking system that should improve its performance over a system of unit independent banks? I think there are two factors operating. The first goes back to the risk factor I discussed previously. The second has to do with the internal workings of a multiple unit system.

TABLE VI

Comparison of Loan-deposit Ratios of Unit Banks  
and Branch Offices in One- and Two-bank California Towns<sup>1/\*</sup>

Banking Structure in Towns	Towns analyzed (number)	Ratio of loans to deposits		High ratio offices ( <u>    .80</u> ) (number)	Percent of total loans at high-ratio offices (percent)
		Aggregate (percent)	Average (percent)		
One-bank (unit)	8	6/65 57.5 12/65 46.7	59.0 49.4	0	0
One-bank (branch)	143	63.6	59.6 <sup>2/</sup>	31	45.4
Two-bank (mixed)					
Unit	12	59.9	68.2	4	17.5
Branch	10	82.7	89.6	4	59.3
Two-bank (both branches)	114	58.6	61.4 <sup>2/</sup>	47	35.0

<sup>1/</sup>Data are based on various periods, including December 1964, June 1965 and April 1966. Two dates are shown for the banks in the 8 one-bank (unit) communities because of the wide difference between June and December. Other groups show little change between these dates.

<sup>2/</sup>Averages include several new branch offices with ratios less than .20.

\*TABLE VIII, p. 21, from published sources implies the same kind of conclusion as TABLE VI but based on more general evidence. Given these two pieces of evidence, it is hard to deny that the introduction of branch banking will lead to an increase in the per cent of total deposits or assets loaned out even in the rural community.

It was previously stated that the reason why rural banks tend to have lower loans to deposits is that there are additional risks incurred because of an inability to diversify their loan portfolios. However, would a branch office or a holding company affiliate face the same problem? For the case of a branch office, the answer is obvious. It does not matter to the system whether a particular office diversifies his portfolio, it is only important that the system have a diverse portfolio. In the case of a statewide branch bank, that would be insured. They would participate in all the various activities of the state they are in. For the case of the holding company affiliates the answer is not quite so simple. However, there are several means available to insure the diversification of the loan portfolio of any bank in the system. The simplest way would be to have member banks around the state exchange loans. However, as long as the system is willing to absorb the losses of an affiliate, the risk problem has been reduced.

The second reason may be the most important one, once the risk problem has been solved. I hinted in the example of the statewide chain of grocery stores that there might be a competitive mechanism which is not usually taken into account. Bigness is not necessarily monopoly and sometimes, if the system operates correctly, there can be real advantages to branch financial institutions. There are two processes which take

place which lead to good performance characteristics.

The first is that within a branching or holding company system there is a constant monitoring of the individual managers and presidents to insure that they perform up to standards set at the home office. The success of any manager or president of the system depends on his relative performance to all the other managers of the system. This performance rating for branch managers is usually in terms of loan accomplishments. Thus in a branching system, for instance, there is terrific pressure for a manager to loan out all his assets, since he knows full well that anything he doesn't loan out will go to another branch office and improve someone else's performance relative to his. No such process exists in a unit independent bank. If the owner of the bank does not perform well, and he is in one of those low density bank counties, there is no force to make him improve his performances.

The second force is the fact that branch and holding company systems tend to compete system wide with the other holding companies and branch systems. Thus they not only compete locally, but their performance is measured statewide or system wide.

#### IV. Conclusions

I mentioned in my introductory comments that the cost of a particular system was in the jobs and income not generated. Although I am not ready to estimate the actual number of jobs which would be created by introducing a branching system, I can estimate the cost of the unit system in terms of loans not made. Using that 5% differential between holding company affiliates and independent unit banks, I estimate that \$161,000,000 worth of additional loans would have been made in 1968 if all banks in Minnesota performed as well as the holding company affiliates.<sup>1/</sup>

That, gentlemen, 161 million dollars, is the price that we pay for maintaining the current banking structure. You must decide if the benefits of the present system are worth that cost.

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<sup>1/</sup>From Table VII it can be seen that the 161 million dollar figure is a lower bound. If you compute the change using the aggregate figure, the result is a 211 million dollar increase.

TABLE VII

The Amount of Additional Loans at Holding Company Rates,  
1968 in Millions of Dollars

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Using Averages by Bank	\$161,000,000
Using Aggregate Totals	\$205,850,000

Derivation Procedure

1. Take the difference between the loan-deposit ratio of holding company affiliates and all other banks from Table V:

$$\text{a. } 51.82 - 47.39 = 4.43 \quad \text{By Banks}$$

$$\text{b. } 58.41 - 52.23 = 6.19 \quad \text{By Aggregates}$$

2. Take the difference as a per cent of the loan-deposit ratio for all other banks:

$$\text{a. } 4.43 \div 47.39 = .093$$

$$\text{b. } 6.19 \div 52.23 = .118$$

3. Multiply by total loans of all other banks:

$$\text{a. } \$1,790 \times .09 = \$161$$

$$\text{b. } \$1,790 \times .118 = \$211$$


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TABLE VIII

Performance Characteristics Classified by Structural Characteristics for Unit Banks in Isolated One- and Two-Bank Towns (Means of Ratios, 1959-1962)\*

Performance Characteristic	All Banks		Number of Banks in Town		Branch Banking		Branch Office		Other Savings Institutions		Distance from Town with 25,000 Population		
	One	Two	Permitted	Not Permitted	Permitted	Not Present in Town	Present	Not Present	Present	Not Present	Present	25 Miles or Less	Over 25 Miles
Interest on Time Deposits to Time Deposits	.0237	.0248	.0211	.0226	.0261	.0226	.0279	.0250	.0213	.0232	.0241		
Time to Total Deposits	.4475	.4785	.3550	.4320	.5332	.4320	.5099	.4905	.3704	.4378	.4564		
Interest on Time Deposits to Total Deposits	.0111	.0122	.0080	.0103	.0139	.0103	.0144	.0126	.0083	.0107	.0114		
Interest and Charges on Loans	.0601	.0606	.0585	.0596	.0616	.0596	.0623	.0605	.0594	.0598	.0604		
Loans to Assets	.3897	.3959	.3430	.3824	.4331	.3824	.4194	.4008	.3700	.3863	.3930		
Net Current Earnings to Assets	.0118	.0114	.0114	.0118	.0121	.0118	.0116	.0118	.0116	.0116	.0119		
Number of Banks	106	57	51	85	55	85	21	68	38	51	55		

Note: Towns are isolated in the sense that there are no commercial banking offices within a radius of five miles. A branch office is defined as the office of a bank having at least 4 offices whose main office is located in a town or city over 5 miles away. Other savings institutions include savings and loan associations and mutual savings banks.

Source: Horvitz and Shull, "The Impact of Branch Banking on Bank Performance," The National Banking Review, December 1964, TABLE 11.