Institute for Public Policy and Business Research
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INTERSTATE BANKING:
A REVIEW OF RESEARCH LITERATURE

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EXECUTIVE SUMMARY

INTRODUCTION

The Institute for Public Policy and Business Research initiated a literature review of research on the effects of the removal of geographic banking restrictions in order to investigate the possible impact of interstate banking legislation on the Kansas economy. A search for current and relevant research literature was undertaken and determined the major issues and findings outlined in empirical studies. This executive summary provides an overview of the key conclusions reached from available evidence.

STRUCTURE OF THE PAPER

The structure of the paper focuses on the present banking structure in Kansas, national interstate banking activity, arguments made against interstate banking, and benefits derived from interstate banking. Because the majority of research has explored opposition to interstate banking, the greater part of the paper offers the results of research which addresses those concerns.

MAJOR FINDINGS OF RESEARCH STUDIES

1. Most states with reciprocal or national interstate banking laws have benefitted from initially passing regional reciprocity legislation and then moving to full reciprocal interstate banking. This two-step approach has been influential in creating and strengthening regional banks, preserving the existing banking structure, increasing access to capital markets, and diversifying loan portfolios through additional lending opportunities.

2. Interstate banking may lead to a slight decrease in concentration in local markets, and both small and large banks will be able to coexist and compete by differentiating products and services. Furthermore, the threat of unfriendly takeovers is low if banks continue to remain competitive and profitable.

3. While the effect of interstate banking on small businesses has not been directly researched, other studies, taken together, suggest that the supply and cost of small business financing will not be harmed by interstate banking, and in fact, it may increase capital available to small businesses.

4. Interstate banking may lead to a more competitive banking system and, in turn, lead to economies of scale and scope, more uniform deposit rates, convenient and easily

accessible delivery systems, and a greater array of products offered at competitive prices.

CONCLUSION

Opposition to interstate banking continues in Kansas, even though most states have already passed regional or national reciprocity legislation. Moreover, it is worth noting that Kansas' banking structure may have a negative effect on economic growth within the state. According to the most recent study on the state's banking structure done by Kansas Inc., Kansas' banking industry is highly decentralized and unconcentrated statewide but is very concentrated at the local level, with 88 of the state's 105 counties exceeding the federal threshold of a highly concentrated market area and 306 communities being served by one bank.

The Kansas Inc. study also found that Kansas' average loan to deposit ratio of 59.8 percent is significantly lower than the national average of 79.8 percent. Larger Kansas banks have a higher ratio than medium and small-sized banks, and if Kansas banks loaned money at a mid-point between the state and national average (68 percent), an additional $2.4 billion in loans would be made. Furthermore, Kansas' loans to deposits ratio is higher than Nebraska and Oklahoma and below Colorado and Missouri.

Taking this information and the research findings of the literature into account, one can see that Kansas could benefit from interstate banking in the following ways: (1) improved access to capital, especially for small businesses as small and medium-sized banks increase their loans to deposits ratios in order to remain competitive and profitable; (2) more diversified banking institutions; (3) stronger regional banks; (4) easier consumer access to banking facilities; (5) greater array of services and products; and (6) more competitive prices and rates. The result could lead to greater statewide economic growth and a more globally competitive banking climate.

INTRODUCTION

Over the last several years, interstate banking legislation has spread quickly throughout the country. A review of research and business literature indicates that the trend has been driven by several factors: (1) national and international market forces; (2) interest rate deregulation; (3) advances in data processing and communications technology; and (4) the proliferation of other financial institutions.[1]

Furthermore, the increasingly global focus of business has created an additional impetus for interstate banking in the United States, and interstate banking could have a direct impact on the financial system, economy, and competitiveness of the United States in the next century.[2] Currently the United States has significantly more commercial banks per capita than any other industrial country, and two out of three commercial banks in the world are chartered in the United States. This sizable difference is due to unique state and federal banking laws in the United States which impose strict geographic limits on banks. Although it is uncertain how interstate banking will affect the international competitiveness of the United States, it has the potential to create massive long-term changes in the United States' banking structure.[3]

The purpose of this paper is to provide a broad overview of interstate banking by reviewing current research literature, and the structure of this paper reflects the body of evidence available about interstate banking. Because most research has focused on opposition to interstate banking and the claims of its critics, the greater part of the paper offers the results of research which studied those concerns. Interstate banking is in the early stages of development, and there is little evidence available about its long-term benefits. Therefore, some short-term benefits are mentioned.

The paper begins by looking at the present structure of the Kansas banking industry and its impact on the state economy. Next, the review explores literature which discusses the evolution of interstate banking over the last decade. Finally, the concerns of those opposed to interstate banking and benefits from interstate banking are discussed. Overall, it can be seen that the harms of interstate banking have been exaggerated and that there is the

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[1]Dave Phillis and Christine Pavel, "Interstate Banking Game Plans: Implications for the Midwest," **Economic Perspectives--Federal Reserve Bank of Chicago**, March/April 1986, p 23.

[2]Richard F. Syron, "The 'New England Experiment' in Interstate Banking," **New England Economic Review**, March/April 1984, p 5.

[3]Syron, p 6.

potential for positive change within the United States' financial system.

PRESENT BANKING STRUCTURE IN KANSAS

In 1988, Kansas Inc. initiated a study of the banking industry in Kansas, especially in the areas of commercial and industrial lending. The research results identify several areas of concern within the state's banking industry:

1. Significant changes in federal regulation, customer interest sensitivity, and competition from non-financial firms have directly affected competition for deposits.

2. Overall, Kansas' banking industry is highly decentralized and unconcentrated.

3. Local markets, however, are very concentrated, with 88 of the state's 105 counties exceeding the federal threshold of a highly concentrated market area and 306 communities being served by one bank.

4. Larger Kansas banks have performed superior than others in the Tenth Federal Reserve District while smaller banks have followed the downward trend of their peers.

5. Kansas' average loan to deposit ratio of 59.8 percent is significantly lower than the national average of 79.8 percent, with larger banks having a higher loan-to-deposit ratio than medium to small sized banks.

6. When compared to its neighbors, Kansas' loans to total deposits ratio is higher than Nebraska and Oklahoma and below Colorado and Missouri.

7. The extent of bank loan activity is related to the size of the bank, instead of other factors such as community size or the state of the local economy, with larger banks having a higher level of activity.

The research also points out that the present banking system may have a negative effect on economic growth in the state. Specifically, the study indicates that if Kansas banks loaned money at 68 percent of total deposits (a midpoint between the present state and national averages of 58.9 and 78.9 percent, respectively), an additional $2.4 billion in loans would be made. Furthermore, the study concluded that "consideration should be given to implementation of policies that help ensure the reduction and

eventual elimination of barriers to growth in a state's banking industry."[4]

NATIONAL INTERSTATE BANKING ACTIVITY

Nationwide interstate banking is prohibited under in the McFadden Act and Douglas Amendment to the Bank Holding Company Act. While some loopholes have allowed nondepository institutions, loan production offices, nonbank subsidiaries of bank holding companies, and Edge Act offices to offer some financial services across state lines, the Douglas Amendment of 1956 allows holding companies to acquire banks in more than one state only if states pass statutes allowing this. Significant interstate activity did not emerge until the 1980s, with the principal form being regional reciprocal compacts, beginning first in the Northeast, following in the South and Midwest.

New England States

It is not surprising that current interest in interstate banking began in New England as the region has always been on the forefront of banking innovation. Maine and New York both passed laws allowing reciprocal interstate banking in 1975 and 1982 respectively. The legislation allowed bank holding companies to do business in Maine, for example, if their home state would allow Maine holding companies to acquire existing banks or establish new ones within their borders.[5]

One of the principal reasons for allowing interstate banking in Maine centered around the fact it was "capital poor" and that the entry of out-of-state institutions would create an expansion of funds through acquisition of banks or creation of de novo banks which, in turn, would inject capital into the local economies or shift funds for lending opportunities to Maine from other areas.[6] Furthermore, the Maine law attempts to prevent capital drains resulting from interstate activity. In New York, however, legislation was passed so that institutions in the state would be able to expand their facilities beyond the borders of the state.[7]

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[4]Kansas Inc. (1988). "Capital Availability and the Kansas Banking Industry," intro.

[5]Syron, p 9.

[6]Donald T. Savage, "Interstate Banking Developments," **Federal Reserve Bulletin**, February 1987, p 80.

[7]Syron, p 9.

In 1982 through 1983, Massachusetts, Rhode Island, and Connecticut followed suit in passing regional interstate banking laws. Rhode Island also included a provision allowing full national interstate banking by 1986, and Maine repealed the reciprocity provision in 1984. The reason for this initial difference in reciprocity is that banks in the northern New England states were interested in being acquired and wanted to increase the possibility of attracting outside buyers, whereas the small to medium-sized banks in the southern New England states were interested in consolidating within New England for some period before competing with larger out-of-state banking institutions.

In early interstate banking activity, the southern New England bank holding companies did not find the northern New England states to be attractive for operating nonbank subsidiaries. There are two reason which may explain this. First, the northern New England states have relatively low per capita incomes, as well as a large number of banking offices relative to their population. Second, because the region is small in size, customers are close to banking facilities in other states.[8] In contrast to this, the southern states witnessed a substantial amount of activity during the 1982-1984 period, with a total of eleven acquisition, merger, or de novo applications. Of the eleven, eight involved New England banks and three others involved New York holding companies.[9]

Southern States

The second regional banking compact began in 1985, when seven Southern states and the District of Columbia passed reciprocal interstate banking legislation.[10] Ten states and the District of Columbia eventually joined the compact, with state's law containing an "anti-leapfrogging" provision stipulating that 80 percent of any acquiring institutions's deposits must be within the region, as defined by that state.

Interstate banking has been beneficial to the region and has led to a creation of strong regional banks, access to capital markets, and additional lending capabilities.[11] Further benefits have been the preservation of the South's banking structure, increased competition within the region, and enhanced regional ability to compete for corporate business with the money center banks, all with little negative impact on the customer.

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[8]Syron, p 10.

[9]Syron, p 12.

[10]Veronica M. Bennett, "Interstate, Southern Style," **United States Banker**, October 1987, p 77.

[11]Bennett, p 78.

Midwestern States

Indiana and Illinois passed the first regional interstate banking laws in the Midwest in 1985.[12] The subsequent merger and acquisition activity is the result of later regional reciprocal legislation in other Midwestern states, such as Michigan, Minnesota, Missouri, Ohio, and Wisconsin. Consolidation was driven by the same factors seen in New England and the South: better return on assets and economies of scale, creation of more capital and jobs, and the number of banks available at reasonable prices.[13] In fact, merger activity in the Midwest has actually surpassed other areas due to the number of banks available at reasonable prices. Banks have also benefitted from mergers activity, especially when diversifying their loan portfolios or strengthening their retail deposit base.[14]

Current Federal Action

In July 1990, two duplicate bills were introduced in the House (HR 5384) and Senate (S 2922) concerning interstate banking. Congressional intent was to:

1. Strengthen U.S. banks by enhancing opportunities for risk diversification.

2. Promote efficiency by removing barriers to entry in banking and making delivery of banking services more cost effective.

3. Make banking more convenient for customers.

4. Expedite current interstate banking progress.[15]

5. Create stronger banks which can better compete internationally.

6. Permit faster movement of capital to needy areas.[16]

The bills would amend the Bank Holding Company Act of 1956 to allow the Federal Reserve Board to approve applications for a bank

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[12]Phillis.

[13]Marilyn Kennedy Melia, "Interstate Action in the Midwest," **United States Banker**, November 1987, p 23.

[14]Melia, p 24.

[15]**Congressional Record**, July 26, 1990, E 2506.

[16]**Congressional Record**, July 26, 1990, S 10844.

holding company to acquire out-of-state banks unless states pass legislation specifically prohibiting the acquisition or creation of banks by out-of-state bank holding companies.

ARGUMENTS MADE AGAINST INTERSTATE BANKING

Opposition to interstate banking in the United States began in the late 18th century and continues today. Opponents of interstate banking are critical of the role of large financial institutions in banking and the effect that interstate banking might have on the concentration of political and economic power; the distribution of credit; the capital adequacy, safety, and soundness of our financial system; and the role of the dual banking system.[17]

Evidence from empirical studies and research based upon bank branching laws and early interstate banking regions does not indicate that these concerns are valid. In particular, commonly held beliefs regarding the negative effects of interstate banking on bank concentration, capital exportation, small bank survival, merger and acquisition activity, effects on small businesses, and the rate of change have been proven false.

Bank Concentration

Increased concentration resulting from interstate banking has created apprehension in both the public and private sector and has been the principle argument against interstate banking. However, studies based on branch banking and early interstate banking legislation do not support this. First, data concerning concentration in unit banking states and branch banking states shows that over the period from 1970-1984, concentration remained virtually the same in unit banking states, declined substantially in limited branching states, and declined sharply in statewide branching states.[18] Furthermore, branching data on rural areas suggests that interstate banking would "probably have less impact on concentration in rural markets but would, if anything, lead to further decreases in market concentration."[19]

Second, early data on interstate banking indicates that the effects of interstate banking has led to a slight decrease in concentration in local markets while increasing concentration

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[17]Syron, p 7.

[18]Herbert Baer, Douglas D. Evanoff, Diana L. Fortier, and Larry R. Mote, "Geographic Deregulation in Banking and the Public Interest," **Issues in Bank Regulation**, Spring 1988, p 10.

[19]Baer, p 11.

nationwide.[20] In fact, the banking resources held by the top 100 banking firms have increased, from 50.4 percent in 1970 to 63 percent in 1988. However, the banking resources held by the very largest banks have actually decreased, from 14 percent in 1970 to 12.9 percent in 1988. There are two reasons for this: (1) regional banking laws have prevented larger banks from entering other states and (2) the financial problems of the larger banks have required their attention and capital.

Other studies conclude that the result of interstate banking will lead to a substantial increase in nationwide concentration of banking resources, with local markets unaffected.[21] Additionally, one study suggests that based on its analysis, there will be a significant decline in the number of banks nationwide, with a relatively small number of nationwide conglomerates and several thousand smaller banks.[22] While the banking structure of the United States will not be as concentrated as other foreign countries, the financial services industry may evolve into a structure similar to the retail market, with large national firms in the same markets as regional and local firms, all competing and successfully differentiating their products.[23]

Whether or not concentration may be kept in check by antitrust laws remains uncertain because it is unclear what effect economic and political trends may have on interpretation and enforcement of antitrust laws. In the past, proposed mergers between relatively large banks in the same market have been discouraged or denied because of the Justice Department's rationale that highly concentrated banking markets worsen banking competition. However, most mergers between banks located in different markets have not been prevented because the courts do not accept the argument that these types of mergers eliminate the outside bank as a potential de novo entrant and thus reduce competitive pressure on existing banks in that market.[24]

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[20]Savage, p 32.

[21]Stephen A. Rhoades, "Concentration in Local and National Markets," **Economic Review**, March 1985, p 30.

[22]Stephen M. Miller, "Counterfactual Experiments of Deregulation on Banking Structure," **Quarterly Review of Economics and Business**, Winter 1988, p 46.

[23]Donald R. Andrews, Jerry M. Hood, and Uday S. Tate, "Banker's Attitudes Concerning Interstate Banking," **Journal of Retail Banking**, Spring 1989, p 20.

[24]Dunham, p 23.

In assessing the impact of mergers on market competition, federal bank regulators have traditionally relied on an examination of the merger on the effect on competition and the "convenience and needs" of the community. In considering the overall impact on concentration and competition, regulators recognize several mitigating factors which may reduce the anti-competitive effects of an increase in concentration:

1. Thrift Competition--thrifts have been seen as strong competitors because of their ability to compete for deposits, consumer loans, and commercial loans.[25]

2. Condition of Acquired Bank--if the acquired bank is in a weak financial condition, then its acquisition by an outside bank may not substantially reduce competition, especially if it has experienced lost market share.

3. Fringe Competitors--the presence of a significant number of fringe competitors or others offering "banking alternatives" represents another long-term competitive threat.[26]

The Federal Reserve has proposed new criteria to be used in order to determine whether or not a merger should be denied. If all four criteria are met, then a detailed examination will be made in order to ascertain the possible competitive effects. The criteria are:

1. The market has a three firm concentration of 75 percent or more.

2. There are fewer than six entrants (banking organizations with more than $1 billion in assets) which could enter the market.

3. The market is attractive for entry.

4. The acquired firm is a market leader.[27]

Capital Exportation

One of the reasons that interstate banking is a controversial topic in banking regulation is due, in part, to the fear that large

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[25]Paul Calem and Janice Moulton, "Competitive Issues in Bank Merger Analysis Under Interstate Banking," **Issues in Bank Regulation**, Winter 1988, p 24.

[26]Calem, p 25.

[27]Calem, p 28.

bank holding companies could enter smaller states, acquire the major banks, and ignore the credit needs of the customers in that state by siphoning off funds to other growing areas in the country. However, there is no systematic evidence to support this.[28] In fact, the evidence actually demonstrates "that banks of all sizes currently invest major portions of their funds in distant locations, either directly through their own office networks or indirectly through interbank and other wholesale markets . . . 12[and] small banks tend to be the conduit for significant outflows of funds from their local communities."[29]

While it is true that small banks are more locally oriented than larger ones, larger banks tend to allocate more of their funds to loans, due to the fact that they have access to more lending opportunities than smaller banks. Furthermore, large banks can have less difficulty in financing increases in loan demands, whereas small banks must tap other sources, such as utilize liquid non-loan assets or maturation of other loans in order to meet unexpected loans. In terms of the locality of the loans, virtually all loans made by small banks are local, compared with less than 40% of large bank loans. The reasons for this are clear. Large banks can develop a long-distance loan network because they have a higher volume of large loans, reducing the per-dollar cost. Smaller banks, on the other hand, are limited in the size and volume of loans they can make due to their capital restrictions.[30]

Non-loan assets, however, are primarily non-local for banks of all sizes, directly challenging the notion that only large banks can shift their funds into outside opportunities.[31] Also, it illustrates the fact that banks of all sizes serve as financial intermediaries, with community banks utilizing many opportunities to indirectly invest in economic activities outside its region. Small banks tend to allocate a significant portion of their funds to non-local banks for two reasons: (1) lending opportunities within their local communities may not be as profitable as ones outside the community and (2) banks need to diversify their portfolio with loans from outside the local area.[32]

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[28]Donald T. Savage, "Interstate Banking Update," **The Banker's Magazine**, July-August 1989, p 30.

[29]Constance R. Dunham, "Interstate Banking and the Outflow of Local Funds," **New England Economic Review**, March/April 1986, p 7.

[30]Dunham, p 8.

[31]Dunham, p 9.

[32]Baer, p 15.

Lending activities on their own do not tell whether or not a bank is a "drainer" or "retainer" of local funds. It is necessary, therefore, to consider the source of funds. Once again, differences in funding sources exist across bank sizes, and larger banks rely on a more diverse set of sources, with the majority of funds coming from national and international money markets and the balance from domestic deposits and bank equity. Small banks, on the other hand, almost exclusively rely on small time and savings deposits, with little or no reliance on foreign deposits and short-term debt.[33] When this is added to the information about the uses of funds, it is clear that small banks should really be seen as pipelines through which a significant portion of local funds leave a community, especially smaller, rural ones.

Small Bank Survival

Many fear that community banks will suffer under interstate banking, having to succumb to a friendly or unfriendly takeover by a larger bank. Evidence shows, however, that community banks can generally make it on their own. The number of banks has risen from 13,500 to over 15,000, despite the failure of over 100 banks a year.[34] Moreover, since the 1960s, several studies have examined the growth of large and small banks in the same community, as well as the growth of small, independent banks before and after a large bank entered their community. Overall, the studies indicate that small banks:

1. grow as fast as large banks
2. do not lose market share when large banks enter their market
3. which are independently started achieve market share at least as fast as those started by large banking organizations
4. are nearly as efficient as large banks
5. are generally more profitable and better capitalized than large banks
6. are capable of adapting to changes in new technology [35]

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[33]Dunham, p 10.

[34]Paul S. Nadler, "Bank Acquisitions - Friendly and Not So Friendly," **Banker's Monthly**, November 1986, p 4.

[35]Stephen A. Rhoades, "Interstate Banking: No Big Threat to Small Banks," **American Banker**, October 11, 1984, p 19.

Therefore, the available evidence shows that small banks will continue to remain viable operations in the interstate banking climate. If independent banks do fail or merge with larger banks, however, it will be for two reasons. First, there are small banks which are inefficient in their operations and unaggressive in their prices and services offered to customers. With strong competition from new entrants, these banks may face failure or merger. It must be kept in mind, however, that the available data points out that these banks are the exceptions, not the norm. Second, small banks may disappear simply because their owners choose to sell their banks.[36]

Mergers and Acquisitions

Most acquisitions have been friendly ones, with the acquired bank and its stockholders receiving a good offer. Unfriendly takeovers, although rare, are not a threat to community banks. The acquiring bank is not only interested in obtaining the deposits, loans, and investments of the bank, but the community goodwill built by management, board, and staff of the bank as well. If the community does not support the new owners, immediate and irreparable damage may result from an unfriendly takeover. Without community backing, the acquirer really gets: (1) the building, which is usually old and not state-of-the-art; (2) all low rate mortgages and loans, which usually stay on the books until the last payment is due, unlike higher rate loans; and (3) core deposits which are highly sensitive to interest rate fluctuations.[37]

It is important to note that unfriendly acquisitions do not take place if management is doing its job by keeping the value of its shares up and taking in all shares offered at low prices in order to have greater control of the stock. Therefore, it is the bottom-line, not size, that determines the success of a bank in thwarting an unfriendly takeover.[38]

Most interstate expansion has been through acquisition of major banks, but there is no evidence demonstrating that the acquiring firms have been able to increase the market share of the acquired banks.

Effects on Small Business

The effect of interstate banking on the cost of financing available to small firms has also been addressed in research.

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[36]Rhoades, **American Banker**, p 7.

[37]Nadler, p 49.

[38]Nadler, p 49.

There are several conclusions regarding the traditional role of commercial banks in meeting the credit needs of small firms:

1. Commercial banks are the second source of funds for small businesses after trade credits.

2. The majority of lending to small businesses is done by small to medium-sized banks.[39]

3. Small firms rely on local banks for funds, and firms in rural communities count on local banks even more than their peers in larger communities. This continues to be the case even after geographic limitations have been eased because the entering regional or money center banks tend to focus their efforts on larger businesses.[40]

A further concern is that once large, multi-state banks take over smaller ones, they will alter the lending pattern of the smaller banks away from small to large businesses. Because no direct empirical research has been done on the effects of interstate banking on the loan mix of acquired banks, other studies have been used to determine the potential outcome. The results are mixed, with some evidence that the credit needs of small firms would not be served as effectively with interstate banking.[41] However, while there is no direct empirical evidence available to resolve this issue, other research has shown that:

1. Holding companies usually exercise some control over the loan mix and loan participation strategies of their subsidiaries. However, there is no evidence from these studies which indicates a possible change in the mix from small to large businesses.

2. Independent banks tend to increase their loan portfolios after being acquired.[42]

3. The market shares of the independent banks do not decrease after being acquired. Therefore, small businesses are not moving their deposits to other institutions in

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[39]John T. Rose, "Interstate Banking and Small Business Finance: Implications from Available Evidence," **American Journal of Small Business**, Fall 1986, p 25.

[40]Rose, p 26.

[41]Rhoades, **American Banker**, p 19.

[42]Rose, p 27.

reaction to a change in the acquired bank's lending patterns.[43]

Taken together, the results of these studies suggests that the supply and cost of small business financing will not be harmed by interstate banking, and in fact, it may increase capital available to small businesses.[44]

Speed of Change

Additionally, the pace of interstate banking has not been as rapid as some might suggest because: (1) money center banks have had loan-loss problems which drained their capital; (2) acquisitions are expensive and most buyers are not willing to dilute their earnings. Forming a de novo bank is expensive, too, and takes a long time to build market share and profitability; and (3) to date, all interstate banking acquisitions have been friendly due to the enormous cost of hostile takeovers.[45]

BENEFITS FROM INTERSTATE BANKING

Once geographic restrictions are removed from the banking industry, economic theory suggests that banks will become more competitive because they will be able to: (1) achieve economies of scale and scope; (2) price their services more competitively; (3) offer convenient delivery systems; and (4) offer standard products at the same prices throughout their office networks.[46] There is, however, conflicting evidence about the differences in economies of scale between large and small banks, with some finding no difference in costs relative to size,[47] but if the removal of banking restrictions increases competition, changes should also take place in bank profitability, service levels, and prices. Although it is too early to fully understand the long-run advantages of interstate banking, research literature on the effects of branching can be used to illustrate the possible outcomes.[48]

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[43] Rose, p 28.

[44] Rose, p 34.

[45] Savage, **The Banker's Magazine**, p 32.

[46] Baer, p 13.

[47] Rhoades, **American Banker**, p 7.

[48] Baer, p 17.

Profitability

Evidence based on results from branching suggests that removal of geographic restrictions on banking reduces profitability. Average profit rates, with market and firm specific differences removed, were examined in order to determine the effect of branching laws. The results indicate that banks in states without branching are more profitable than those in states with branching, and this may be due, in part, to the relatively more competitive branching environment. The study did not address, however, the issue of whether or not long-run profitability would increase due to improved product and service differentiation, a greater array of available services, and more efficient operations.

Concentration was found to be an important indicator of profitability in states prohibiting branching, but not in states allowing branching. This implies that concentration has a greater impact on profitability only when competition is blocked by regulatory, not market, forces. In fact, in states without regulatory restrictions, firm-specific efficiency appears to be a more important determinant of profitability. In the interstate banking environment, then, market forces may drive the profitability of banks down, but banking concentration will have little impact on the bottom-line.

Service Levels

One aspect of service is the accessibility of facilities to the customer. For example, in states with banking restrictions, banking offices usually serve more customers per facility, illustrating a relative lack of consumer convenience.[49] Because larger banks traditionally offer more services and make more loans, in areas where banking restrictions are relaxed, smaller banks may also expand their services in order to compete. Improved servicing of consumer loan needs has taken place in areas with less restrictions, due to the fact that larger institutions have more diversified portfolios and can then, in turn, hold fewer liquid assets and are able to make more loans.

Prices

Economic theory would suggest that if the quality of bank services remain the same while competition increases, the result should be lower rates on loans or higher interest on deposits. However, it has been shown that bank services do not remain constant, and in fact, more lending, a greater array of services, and an increase in accessibility result from branching liberalization. This may partially account for the elimination of any price differential in more competitive markets. Research also indicates

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[49] Baer, p 13.

that the removal of geographic restrictions may lead to lower service charges and real estate interest rates.[50] Furthermore, removal of geographic barriers through interstate banking would tend to create more uniform deposit rates reflecting conditions in the nation's most competitive markets.[51]

Merger and Acquisition

The operations of an independent bank change once a it becomes part of a larger bank. The effects of affiliation on the small bank's portfolio reflects both the advantages of their small size in maintaining personal contact with customers, in addition to their new ties to the larger banks. Small affiliated banks channel much more of their funds to other banks than do small independents. These interbank transactions are primarily sales to larger banks, usually lead bank affiliates.

The difference, however, between independent and affiliated banks is that the large bank may encourage its affiliates to continue to specialize in their traditional fund-gathering function. Furthermore, the evidence suggests that expanded interbank flows do not represent an increased outflow of local funds; rather, the funds are redirected from their use, away from the government sector and towards large businesses, foreign entities, and other customers of the larger banks.

Affiliation also leads to an increase in direct lending, especially to businesses. Additionally, the subsidiary banks begin to service larger customers by offering new services which usually appeal primarily to medium-size or large businesses. It is difficult to determine whether or not the customers of the affiliate continue to be local. Still, a small bank continues to be better informed about the local economy, compared to the larger bank, and this advantage may support the contention that the bank will continue to service its local customers.[52]

CONCLUSION

The debate over interstate banking will continue, even though most states have already passed regional or national reciprocity laws. Furthermore, recent research by Kansas Inc. shows that Kansas' present banking structure may have a negative effect on economic growth in the state and is not competitive in the global

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[50]Baer, p 14.

[51]Baer, p 15.

[52]Dunham, p 15.

economy. While the present state policy has avoided statewide concentration and control over the allocation of credit, it has created heavily concentrated and uncompetitive local markets.

In sum, research based on the present state and national banking structure and the possible effects of interstate banking shows that:

1. Most states with reciprocal or national interstate banking laws have benefitted from initially passing regional reciprocity legislation and then moving to full reciprocal interstate banking. This two-step approach has been influential in creating and strengthening regional banks, preserving the existing banking structure, increasing access to capital markets, and diversifying loan portfolios through additional lending opportunities.

2. Interstate banking may lead to a slight decrease in concentration in local markets, and both small and large banks will be able to coexist and compete by differentiating products and services. Furthermore, the threat of unfriendly takeovers is low if banks continue to remain competitive and profitable.

3. While the effect of interstate banking on small businesses has not been directly researched, other studies, taken together, suggest that the supply and cost of small business financing will not be harmed by interstate banking, and in fact, it may increase capital available to small businesses.

4. Interstate banking may lead to a more competitive banking system and, in turn, lead to economies of scale and scope, more uniform deposit rates, convenient and easily accessible delivery systems, and a greater array of products offered at competitive prices.

The primary focus of the interstate banking debate in Kansas has centered on the potential impact on small, community banks. There is little evidence to support the fears that small banks will suffer or disappear with interstate banking. In fact, research shows that small banks can remain competitive if they maintain: (1) a customer-based focus in offering services and loans and (2) profitable and efficient operations. Small businesses in Kansas may also see increasing financing opportunities as small and medium-sized banks increase their loans to deposits ratios in order to remain competitive and profitable.

Overall, Kansas may benefit from interstate banking, in terms of improved access to capital, more diversified banking institutions, and stronger regional banks. The result could lead to greater economic growth and a more globally competitive banking

climate. Also, interstate banking could reduce local concentration in Kansas banking markets, increasing bank aggressiveness on a customer level, leading to easier consumer access to banking facilities, a greater number of services and products to choose from, and more competitive prices and rates.

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