

# Chicago Fed Letter

## 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.

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.

**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.<sup>1</sup>

As of June 30, 2006, Illinois boasted 4,349 banking offices, two-thirds more than in 1994.<sup>2</sup> 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.

### The history of branch banking in Illinois

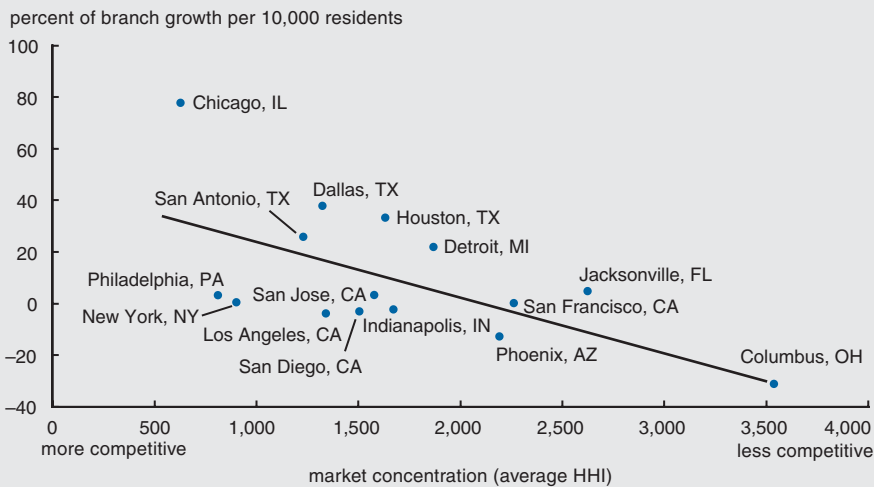
In large part, the current trend in banking office growth is a product of Illinois' banking history. Restrictive bank branching laws in Illinois suppressed expansion for decades. With the relaxation of these restrictions, the number of banking offices has increased sharply in the last dozen years or 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.<sup>3</sup> 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.<sup>4</sup>

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.



## 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](http://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.<sup>12</sup> 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.<sup>13</sup>

### 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.<sup>14</sup> Lobbies for small banks in Illinois had the political clout for many years to defeat attempts to liberalize the state's branching laws.<sup>15</sup> 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.<sup>16</sup> 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.<sup>17</sup> 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.<sup>18</sup>

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.<sup>19</sup> 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.<sup>20</sup>

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.<sup>21</sup> 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.

<sup>1</sup> 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.
- <sup>2</sup> Branching statistics in this article are calculated by the authors using Federal Deposit Insurance Corporation (FDIC) data.
- <sup>3</sup> 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.
- <sup>4</sup> Bank branching is governed by both federal and state level laws; laws at either level may affect branching across state lines (*interstate* branching) and/or branching within a state (*intrastate* 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.
- <sup>5</sup> 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](http://www.usdoj.gov/atr/public/testimony/hhi.htm).
- <sup>6</sup> 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.
- <sup>7</sup> George Kaufman, 1985, “Banking without the barriers,” *Chicago Tribune*, January 15.
- <sup>8</sup> Eugene Nelson White, 1983, *The Regulation and Reform of the American Banking System, 1900–1929*, Princeton, NJ: Princeton University Press, pp. 196–197.
- <sup>9</sup> David A. Alhadeff, 1962, “A reconsideration of restrictions on bank entry,” *Quarterly Journal of Economics*, Vol. 76, No. 2, May, pp. 246–263.
- <sup>10</sup> 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.
- <sup>11</sup> 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.
- <sup>12</sup> 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.
- <sup>13</sup> 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.
- <sup>14</sup> 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.
- <sup>15</sup> 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.
- <sup>16</sup> Kroszner and Strahan (1999).
- <sup>17</sup> 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.
- <sup>18</sup> Kane (1996).
- <sup>19</sup> Department of Banking and Consumer Finance v. Clarke, 809 F.2d 266 (5th Cir.) cert. denied, 483 U.S. 1010 (1987).
- <sup>20</sup> Hal Hopson, 2006, “De novo branch performance: Portfolios and places,” presentation at BAI Retail Delivery Conference and Expo, Las Vegas, NV, November 16.
- <sup>21</sup> 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.