

Economic Commentary

ISSN 0428-1276

Bank Expansion in Ohio

by Gary Whalen

Both economic theory and available empirical evidence suggest that the relaxation of geographic restraints on bank expansion, particularly *de novo* expansion, promotes actual and potential competition in banking markets. Greater competition, in turn, benefits consumers by increased and improved financial services. If geographic barriers to entry do not exist, each banking organization operating in a given market is pressured to provide the mix of services desired by consumers at prices reflecting the lowest possible costs of production. Failure to do so would result in revenue declines and ultimate loss of market share. Geographically unconstrained rivals that operate within or on the fringes of a market can be expected to perceive market opportunities resulting from a competitor's inferior performance; rivals might react by branching, either *de novo* or through merger/acquisition, into and/or throughout the market in an effort to attract profitable business.¹ Just the threat of entry by legally

1. *De novo* entry, which implies entry by an additional organization, is thought to be more pro-competitive than entry through merger. However, entry through merger by an aggressive institution may intensify competition, even though the number of competitors is unchanged.

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The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

uninhibited rivals and knowledge of the attendant consequences should spur the performance of banks operating in any given market.²

In recent years, increasing numbers of state and federal bank regulators, legislators, and bankers have recognized the validity of the arguments outlined above. As a result, several states have elected to liberalize existing geographic restrictions on multi-office banking.³ With the enactment of branching law changes effective in January 1979, Ohio became one such state.⁴ Insight into the impact of reducing branching barriers can be gained from analysis of bank expansion in Ohio since 1979. This *Economic Commentary* details the provisions of Ohio's current branching law, analyzes *de novo* branching patterns, and discusses merger and acquisition activity that has occurred since 1979. Several factors that

2. For discussion of these issues, see Alan McCall, "The Impact of Bank Structure on Bank Service to Local Communities," *Journal of Bank Research*, Summer 1980, pp. 101-9; and Donald Savage, "Branching: The Competitive Issues," *Journal of Bank Research*, Summer 1980, pp. 111-21.

3. Under the terms of the McFadden Act and the Douglas Amendment to the Bank Holding Company Act, each state is essentially free to determine its own policy with respect to bank branching.

4. The states of New York, New Jersey, Virginia, and Florida have liberalized their branching laws in recent years. Branching liberalization has been debated in Colorado, Texas, West Virginia, Tennessee, and Illinois.

might influence bank expansion in the future also are discussed.

Ohio's Branching Law

Ohio's current bank branching law, which became effective January 1, 1979, permits *de novo* branching by a commercial bank within its home office county and into all counties contiguous to its home office county.⁵ Statewide branching through merger also is permitted, with the resulting organization retaining all of the branching privileges enjoyed by all institutions involved prior to the merger. Statewide *de novo* branching is authorized beginning in 1989.⁶ Prior to 1979, *de novo* branching was restricted to a bank's home office county. However, multi-bank holding companies could acquire banks in any county of the state before the 1979 changes in Ohio's branching law.⁷

State and federal regulators influence branching patterns permitted under the Ohio law, as they are charged with evaluating the financial, competitive, and convenience and needs impacts of *de novo* branching and mergers. Generally, regulators view *de novo* branching as pro-competitive and approve most requests for this type of expansion. Branching through merger is subject to more intense scrutiny because of its potentially anti-competitive impact.

De Novo Bank Branching: 1979-80

De novo branching patterns evidenced since 1979 indicate the impact of branching

5. Ohio is classified as a limited branching state. Currently, 22 states permit statewide *de novo* branching; 11 states prohibit branching; and the remaining 17 states impose some limitation on commercial bank branching.

6. The 1979 law also prohibits the statewide deposit share of any banking organization from exceeding 20 percent.

7. As of year-end 1978, 28 bank holding companies existed in Ohio. These organizations controlled 158 bank subsidiaries, 1,328 bank offices, and \$26 billion in total deposits. These numbers represented 33 percent of all Ohio banks, 55 percent of all bank offices, and 66 percent of total state deposits.

liberalization on Ohio's banking structure and suggest the direction of future trends. A great deal of branching activity has taken place in Ohio over the two-year period (see table 1). In 1979-80, 180 *de novo* full-service branches were established, representing a 39 percent increase over the total number established in the 1977-78 period. Holding company affiliates, responsible for 61 percent of the total branches established, were aggressive branchers. In the preceding two-year period, holding company subsidiaries accounted for just 50 percent of the total branches established. Over the 1979-80 interval, 79 different banking organizations (20 holding companies and 59 independent banks) engaged in *de novo* branching activity; 53 organizations established 1 branch each, 18 organizations established from 2 to 5 branches, and 8 organizations established 6 or more. The state's largest banking organizations were responsible for much of the *de novo* branching activity. The largest 3 organizations established 38 branches (21 percent of the total); the 5 largest were responsible for 50 branches (28 percent); and the 10 largest established 82 offices (46 percent).

In all, 52 of Ohio's counties experienced some *de novo* branching activity. Five or more branches were established in 13 counties. Sixteen *de novo* branches were established in Franklin County, 15 in Cuyahoga County, 10 in Lake County, and 9 each in Clermont, Montgomery,

Table 1 *De Novo* Branches
Established: 1979-80

	Holding company affiliates	Inde- pendent banks	Total
Total <i>de novo</i> branches	110	70	180
In-county branches	81	54	135
Contiguous- county branches	29	16	45
SMSA county branches	102	38	140
Non-SMSA county branches	8	32	40

Table 2 SMSA Branching Activity: 1979-80

SMSA	<i>De novo</i> branches	Holding company branches	Independent bank branches	Percent change, bank offices, 1979-80	Number of organizations branching	Percent of organizations branching
Akron	10	10	0	7.1	6	50
Canton	8	5	3	9.6	3	23
Cincinnati	20	17	3	10.2	9	50
Cleveland	30	25	5	8.0	10	43
Columbus	18	16	2	9.6	11	43
Dayton	17	14	3	11.4	6	22
Lima	4	2	2	6.2	4	19
Springfield	5	2	3	14.2	3	33
Toledo	12	6	6	8.1	7	32
Youngstown	5	0	5	4.9	4	33
Total	129	97	32	8.7	—	—

and Stark counties. The vast majority of *de novo* branches (78 percent) were established in the heavily populated, higher-income, urban SMSA counties (see table 2).

The bulk of *de novo* branching (75 percent) represented in-county expansion activity. This type of expansion alters the size distribution of banks competing in a given county, while leaving the number of competitors unchanged. The competitive impacts of this type of expansion depend on the relative number and location of the branches established by all banks operating within the given county, as well as on the type, quantity, quality, and prices of the services offered. The impact of in-county expansion on competition is thus ambiguous. However, it is likely that this type of expansion benefits the public if the new branches offer additional services and/or are conveniently located.

Forty-five branches (25 percent) were established in contiguous counties. Most of this activity (64 percent) was accounted for by holding company affiliates. Contiguous-county branching occurred in 21 different counties. Six branches were established in Stark County by two out-of-county organizations; five were established in Lake County by two out-of-county organizations; four were established in Warren County by three organizations; and three were estab-

lished in Clermont County by three organizations. Some of this contiguous-county branching represented in-market expansion by banking organizations located in multi-county markets.⁸ However, entry by out-of-county organizations in 14 of these counties represented a new competitor's entrance into a local market, which subsequently should intensify competition in these markets.

It should also be noted that 17 off-premise automatic teller machines (ATMs) were installed in this period—10 by holding company subsidiaries and 7 by independent banks. Under current law, regulatory authorities make no distinction between off-premise ATMs and full-service branches.

Merger/Acquisition Activity: 1979-80

Statewide branching through merger also was authorized in the 1979 law. Despite the increased latitude to branch *de novo*, it is not surprising that merger/acquisition activity increased sharply in the 1979-80 period compared with the previous two years. This mode of expansion permits the acquisition of a going concern and eliminates a competitor from the market entered. As in *de novo* expansion, holding companies and

8. Multi-county SMSAs are typically viewed as urban banking markets, while single counties are viewed as rural banking markets.

their affiliates dominated this activity, accounting for 74 percent of all mergers and acquisitions and 76 percent of all offices acquired (see table 3). Eleven different holding companies made at least one merger/acquisition; five engaged in three or more. The three largest organizations engaged in seven merger/acquisitions, totaling 33 bank offices and \$0.4 billion in deposits. The numbers for the 5 largest organizations were 13, 66, and \$0.9 billion; those for the 10 largest were 27, 108, and \$1.3 billion. Forty-seven mergers took place in 35 different counties; 21 took place in SMSA counties and 26 in non-SMSA counties. Holding companies entered six counties for the first time through merger/acquisition during this period.

Several multi-bank holding companies also consolidated totally or partially, i.e., transformed all or some of their banking subsidiaries into branch offices through merger. Because such consolidations are essentially reorganizations, they do not alter the number of bank competitors operating in local markets and, therefore, should not appreciably influence the state of competition in the affected locations.

It should also be noted that four holding companies were formed through acquisitions in 1979-80. Three of these involved the 16th, 19th, and 42nd largest banks in Ohio, with combined deposits totaling approximately \$1 billion. Given the expansion patterns noted above, it is probable that these organizations will expand geographically in the future.

Other Regulatory Influences

In addition to Ohio's branching law, several other factors may influence future branching trends in the state. The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) will substantially alter the structure of financial markets. Prior to the passage of this act, commercial-bank, full-service, conveniently located branches were important competitive weapons. Banks possessed several asset/liability powers not granted nonbank depository institutions, most notably demand-deposit powers, which gave banks an advantage in competing for low-cost retail deposits. Because Regulation Q constrained rates payable on deposits, competition for this source of funds was basically on a non-price basis.

The Monetary Control Act permits savings and loan associations (S&Ls) to offer essentially the same retail cluster of services as commercial banks, including transaction accounts. The act also provides for the gradual phaseout of Regulation Q over a six-year period and the elimination of the quarter-point thrift differential on deposit interest rates. Future competition for retail deposits may increasingly be on a price basis. Additionally, in the current high-interest-rate environment, low-cost demand and savings deposits are dwindling as rate-sensitive consumers continue to shift their funds into financial instruments bearing market rates of interest.

Like their counterparts in several other states, Ohio S&Ls have broader branching powers than commercial banks and so can utilize their expanded powers throughout the state. Indeed, in 1979-80, Ohio S&Ls established 149 *de novo* branches throughout the state; 118 of these were in SMSA counties. Thus, it appears likely that competition for all types of retail business will intensify in Ohio in the future.

Any alteration in federal regulations governing intra- and interstate banking expansion also could influence Ohio bank branching trends. The recently released study by the Carter administration discusses the merits

Table 3 Merger/Acquisition Activity^a

	Holding companies or affiliates	Independent banks	Total
Mergers/ acquisitions	35 (10)	12 (6)	47 (16)
Bank offices acquired	116 (40)	35 (7)	151 (47)
Total deposits acquired, billions of dollars	1.5 (0.4)	0.4 (0.09)	1.9 (0.5)

a. Excluding holding company formations and consolidations. Numbers in parentheses are totals for 1977-78 interval.

of alternative strategies for liberalizing existing federal regulations limiting geographic expansion by banking organizations.⁹ One proposal suggests easing existing restrictions on electronic branching. Among the options discussed are statewide, within-SMSA, contiguous-state, and nationwide branching through ATMs. Several possible alterations in the Douglas Amendment's prohibition of interstate acquisitions by bank holding companies also are mentioned. Among the options presented are permitting holding company acquisitions or, alternatively, *de novo* branching within SMSAs and into contiguous states. In this regard, it should be noted that portions of six of Ohio's SMSAs lie in bordering states. Additionally, 21 holding companies with deposits exceeding \$1 billion operate in states contiguous to Ohio. The study also recommends changes in the McFadden Act. One option considered is statewide branching by national banks. This would put pressure on states to adopt similar regulations or face the prospect of charter conversion by state-regulated banks.

Expansion patterns in Ohio might also be altered if the *de facto* regulatory prohibition of bank holding company acquisition of thrift institutions were relaxed. The Federal Reserve Board recently asked for comment on this issue, and the Justice Department indicated support for the elimination of this ban.¹⁰ Holding companies in Ohio might choose to expand through such an acquisition, given the wider branching powers of S&Ls. Indeed, this mode of expansion might be encouraged if regulators and the courts continue to treat S&Ls as less-than-full competitors of commercial banks. In this case, a holding company might be permitted to acquire an S&L in a market

in which it could not acquire another bank because of antitrust reasons.

Conclusion

Many banking organizations in Ohio have expanded geographically since 1978. Holding companies, typically the largest banking organizations, have expanded more aggressively than independent banks, both *de novo* and through acquisition/merger. However, it does not appear that geographic expansion by Ohio's larger holding companies has resulted in appreciable gains in market share (see table 4). Indeed, examination of changes in the statewide deposit shares of the largest banking organizations over the last two years indicates that these organizations have barely managed to hold their own relative to their smaller rivals, despite their extensive expansion activities.

Because markets for many financial services are thought to be local, the impact of the changed branching law on the number and size distribution of actual and potential competitors operating in Ohio's local banking markets is of greater interest. Most of the *de novo* branching was of the in-county variety and, hence, did not represent market entry by additional competitors. Data on contiguous-county branching over the past two years reveal that branch entry in 14 of the 21 counties was by a new competitor. Actual competition should intensify in these areas. The increased ability and willingness of commercial banks to branch more freely under the new law should make all organizations more cognizant of potential competition as well.

The impact of actual and potential regulatory changes on bank branching in Ohio is difficult to predict. The DIDMCA-related stimulus to competition for diminishing retail deposits may render full-service *de novo* branching a costly competitive strategy, particularly for banks located in Ohio's urban areas. On the other hand, a more competitive environment may precipitate some measure of defensive branching activity. If limitations on interstate expansion are relaxed, some out-of-state organizations

9. For details on the proposals of this study, see "What the Report Recommends," *American Banker*, January 2, 1981. For an analytical discussion of the alternatives, see Alan McCall and Donald Savage, "Branching Policy: The Options," *Journal of Bank Research*, Summer 1980, pp. 122-26.

10. See Lisa McCue, "Justice Opinion Puts Heat on Fed for Bank-S&L Linkups," *American Banker*, May 4, 1981.

Table 4 Ohio Bank Structure Data^a

	Share of total bank offices, 12/80	Change in share since 12/78	Share of total deposits, 12/80	Change in share since 12/78
All holding companies	59%	+4%	67%	+1%
Largest three organizations	20%	+2%	25%	-1%
Largest five organizations	31%	+4%	36%	-
Largest ten organizations	49%	+5%	56%	+1%

a. Excludes impact of holding company formations.

can be expected to enter Ohio. Similarly, some of Ohio's larger banking organizations might elect to expand into contiguous states. However, interstate expansion in the region would be modest relative to what would occur in the rapidly growing areas of the country.

If restrictions on interstate expansion are not altered, it is possible that future bank geographic expansion in Ohio may shift toward electronic branches and/or merger/acquisitions. Off-premise electronic branches provide locational convenience to bank customers typically at costs below those of full-service branches. Geographic

expansion through merger/acquisition gives the acquiring institution a fully staffed, going concern with an established customer base in the market entered and simultaneously eliminates one competitor. Because of DIDMCA, regulators and the courts increasingly may consider thrift competition in their competitive analysis of proposed bank mergers; hence, expansion through this route may become easier in the future. Indeed, if the current regulatory position concerning inter-industry acquisition is altered, Ohio banks might choose to expand by acquiring S&Ls in years to come.

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