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BRANCH BANKING

"Branch banking has been recognized by the foremost authorities on banking in the United States as a natural method of extending banking facilities to small communities, as presenting opportunities for diffusing business risks over larger areas than at present with a gain analagous to that which such diffusion brings to insurance, and as having the advantage of ability to make loans from a common fund of capital and deposits in accordance with the unequal and varying demands of different industries and sections served. There is reason to believe that the agricultural sections of the United States would be far better served, and with the deposits of the farmers much more adequately safeguarded, under systems of branch banking, whether limited to counties or state wide, than at present. California is trying the experiment, and no evidence has so far been presented to show that it is not serving the people of the State well."

This is the concluding paragraph of a report made to the Federal Reserve Board on November 7th by a minority of a committee which had been making a study of branch banking with particular reference to California. The majority of the committee, and the Board itself by majority vote, decided upon a policy of restriction with respect to further extension of branch banking, except within the limits of cities where in accordance with a recent opinion of the Attorney General National Banks are permitted to open additional offices with somewhat limited powers.

Branch banking is authorized in 17 states, exists to some extent in more than half of the 48 states of the Union, and has established itself also in the District of Columbia. State wide branch banking has been authorized for many years in several southern states, but has made little progress except in California and Rhode Island. Country bankers throughout the United States have been considerably agitated about it, and have passed vehement resolutions denouncing it at meetings of the American Bankers' Association - but experience shows that they have nothing to fear if they are well managed, large enough to meet the needs of their communities, and can spread their risks over a sufficient variety of industries to make them safe. No system of branch banking can grow unless there is real demand for it, unless it meets the needs of the people better than independent unit banks can meet them. On the other hand, if in any community it becomes evident that unit banking is not meeting the needs of the people or involves too much risk of failure, nothing can long prevent the people from obtaining a system that will serve them better. Branch banking and independent unit banking will exist together, with very little replacement of the one by the other, as has long been the case in the southern states, unless unit banks have failed to meet the need of the people or some special conditions make necessary a change.

City branch banking has made rapid progress during the past ten years because of special conditions, the chief of which is the congestion of the streets in the business and financial centres of our large cities due to the enormous number of automobiles in use. The banks in the business centres have been losing deposits because many of their depositors find it increasingly difficult to get to them. Since the people cannot get to the banks it has been necessary to bring the banks to the people. The argument is exactly the same as the argument for branch post offices, and is unanswerable. A few cities, the chief of which is Chicago, are still resisting the inevitable, or endeavoring to meet it by the subterfuge of surrounding themselves with outlying chain banks, nominally independent but in reality controlled by downtown institutions. In some way or other the conditions must be met and branch banking from the large, well established institutions offers undoubtedly the best solution, both from the standpoint of the people who demand the best service and the greatest security for their deposits, and from the standpoint of the stability of the banking system of the cities and of the country. New York, Boston, Buffalo, Cleveland, Detroit, New Orleans, Los Angeles and San Francisco are cities in which branch banking has made most progress, and there are a few branch banks in Philadelphia, Providence, Baltimore, Cincinnati, Indianapolis, Atlanta and some other cities, including nearly all the cities in states which authorize state wide or county branch banking.

The argument for branch banking beyond city limits, whether state wide or by counties or limited districts, is very different from the argument for branch banking within city limits and contiguous territory. Many branch banks within the limits of large cities, and suburban residence territory, are properly described as "tellers' windows", conveniences for receiving deposits, cashing checks, etc. They receive money but make few loans, because they have little demand for loans. Branches outside of these limits, particularly in great agricultural states like California, are more often loaning branches. At times when there is a great seasonal demand for financing the fruit growers, or the cotton growers, or wheat growers, such branches loan much more than they have received in deposits, obtaining their funds from the surplus deposited in the city branches. In older, thickly settled eastern states, where there is much wealth in all the small cities and villages, there would seldom be the same contrast between city and country and branch banking would be of comparatively small advantage. If authorized by counties it would enable a few communities to obtain banking facilities where now none exist because the communities are too small to support independent banks. Even if state wide branch banking were authorized in such states as New York or Massachusetts or Pennsylvania I do not believe it would make much progress unless forced by a drastic increase in the amount ofcapital required for organizing banks. The present country banks are generally old institutions, with a considerable accumulation of surplus, and are serving their communities well and at low rates. Cities are close together and if the needs of a large industry in one place cannot be fully met by the banking resources of the town it is easy to arrange for additional accommodation from larger banks in larger places. It should be remembered always that in Canada branch banking is practically required by law. No bank can be organized within the Dominion with a capital less than $500,000, and if banking facilities are to be extended to small communities at all it must be by branches.

In the absence of laws permitting branch banking several middle western states have passed laws allowing the organization of banks with a capital as small as $5,000. Prof. Charles F. Dunbar, who was for many years the leading authority on banking in the United States, pointed out as long ago as 1892, referring to the Nebraska banking act of 1889, that in authorizing banks with so small a capital "the sparsely settled states are attempting to secure by the multiplication of independent banks, the same advantage that

England and Scotland have obtained through the multiplication of branches by a limited number of banks." "These considerations," he adds, "undoubtedly show that the state banking systems, in the present condition of the country, have an important sphere to fill; and they raise the question, moreover, whether the national banking system might not be adapted by judicious amendment to meet wants which it cannot now supply." Professor Dunbar did not, however, advocate the reduction of the limit of capital for national banks, then $50,000, but declared that "the greatest possible diffusion of banking facilities, under an admirably guarded system, might be secured if the establishment of branches were encouraged and facilitated by law." He recognized that in the present state of opinion branch banks "would have to contend with some local jealousies; but any real improvement in commerce or finance is tolerably sure to make good its footing. It is obvious also that if the multiplication of branches were once fairly recognized again in the United States as a natural method, as it has been in the past, it would be as available for central banks under the state systems as for national banks." There follows a summing up of the advantages of branch banking much as I have given them in the opening paragraph. It would be "unnecessary to provide a full board of directors for every establishment, large or small - a necessity which is often embarrassing in small places." It would "tend to diffuse business risks over somewhat larger areas than at present, with a gain analagous to that which such a diffusion brings to insurance." It would be possible "to apply banking capital at a given moment according to the unequal and variable needs of the different parts of any section covered by a given institution and its agencies."

A. B. Hepburn, Comptroller of the Currency in 1892, recognized the advantages of branch banking, but had other and more pressing reforms to advocate.

His successor, James H. Eckles, whose administration felt the full force of the very serious panic of 1893, advocated in 1896 an amendment to the National Banking Act, permitting national banks to locate branches "in places not having national banks already established." As this privilege would be open to all national banks he did not believe it could lead to monopoly - the bugaboo always held up by opponents of branch banking whenever the subject is brought forward.

Congress, however, did not enact the proposed amendment, but contented itself in 1900 with lowering the limit of capital required for national banks from $50,000 to $25,000, and provided that national bank notes could be issued to the par value of government bonds deposited with the Comptroller to secure circulation. The national banking system lost the opportunity to take the lead, the measures adopted in 1900 turning out just as Dunbar had predicted, "palliatives," which did not go to the root of the evils complained of. Enough $25,000 national banks were organized to make a fair showing in numbers, and the profits of all national banks from the note issue monopoly were sufficiently increased to check for a time the tendency to convert into state banks, but the smallest national banks were not small enough to reach out to the people of the agricultural states in anything like even competition with the $5,000 and $10,000 state banks, nor were the larger national banks in the cities able to do more than hold their own in number. In the ten years 1899 to 1909 state banks with a capital above $50,000 increased in practically the same numbers and at a much greater percentage than national banks, and during that period state banks were beginning to take advantage of the opportunity to obtain another long lead in some of the cities by establishing branches. It was in 1909 that California revised its banking laws providing for state wide branch banking.

The attempt to diffuse banking facilities among the people of agricultural states by the multiplication of small independent unit banks had already been recognized as a failure in 1907 and 1908, and the campaign of 1908 for the guarantee of bank deposits was an effort to bolster it up, so that the small banks could command sufficient confidence from the farmers and merchants of the smaller towns to keep their deposits. When the campaign for guaranteeing deposits failed as a national proposition many of the middle western and a few southern states took it up and for a time the state guarantee systems seemed reasonably successful, and became an additional means of building up state banks at the expense of the national system.

California, developing with unprecedented rapidity its wonderfully diversified agricultural resources, would have none of the new panacea but put her banking structure on a firm foundation, in accordance with the principles of banking which had proved their soundness and efficiency. Departmental banking, the separation of savings departments and trust departments from commercial banking, though carried on by the same institution, was one of the leading features of the new law, and state wide branch banking was another. Only one institution has taken full advantage of the state wide provisions of the law and its development, though remarkable, was not sufficiently rapid to attract much outside attention until the past few years. Other institutions in San Francisco and especially in Los Angeles have entered the field and although their branches do not cover so much of the state they have approached or surpassed it in numbers. According to the recent report of the Comptroller of the Currency 82 State banks in California are operating a total of about 475 branches. "In the State one bank operates 28 branches, one bank 19 branches, another about 71 branches in 48 different cities, another about 72 branches. Four banks in California operate a total of 190 out of the 475 branches in the State." The Comptroller does not explain, however, that a very large proportion of the branches of the largest institutions are within city limits. The largest banking institution in Los Angeles has 16 branches within the city and 12 outside. Nor has he said anything about the service which the branch banking institutions have been able to render the state in the crisis through which the country has passed. Recent testimony has shown that the two branch banking institutions which maintain the most outside branches have loaned in a dozen different agricultural communities more than the total deposits of each of those districts - in some of them more than double their deposits. No unit banking system can do that, even if borrowing to the limit from the Federal Reserve System or from correspondent city banks. Furthermore, it has been shown that in many cases they have lowered the rate of interest the farmers pay to something approaching eastern rates (generally from 8% to 7%) and have done away with various exchange charges and commissions that were vexatious and sometimes burdensome.

The Comptroller wants to restrain the State banks of California from any further extension of this excellent service because national banks are not allowed to engage in it except in limited degree and at a marked disadvantage. I disagree with him. Congress has had the same opportunity to enact progressive banking legislation that the California legislature has had, and the Federal Reserve Act does not cure all the ills of unit banking. The California banking act of 1909 has so far at least proven itself better adapted to the needs of California than the national banking laws, and it is a significant fact that there have been less state bank failures in California not only since August 1920, but since 1909, than of national banks (three state, six national since 1909). I doubt if there is any other state in the Union of which that can be said. Besides the branch banking institutions approximately 263 national banks and 348 state banks have no branches.

The leading branch banking institutions of California are members of the Federal Reserve System, but have not at any time been large borrowers from the System. One of the largest has never borrowed, and one or two of the others have never borrowed except to carry Liberty bonds. They not only weathered the recent financial crisis better than the independent banks, but furnished nearly a third of the reserve deposits from which the Reserve Bank of San Francisco helped the unit banks which were hard pressed. The agricultural crisis was as severe, when the great fall of prices occurred, in California as anywhere else in the country, but there was no lack of credit from the branch banking systems. These systems are well managed, and are able to give extraordinary service to the people through their ability to spread their risks over a wide area, so that they obtain the advantage "which such diffusion brings to insurance," as Dunbar said, and "can apply their banking capital at a given moment according to the unequal and variable needs of the different sections." California is doubtless peculiarly adapted to branch banking because of its great extent, its variety of climate and of agricultural products, which mature at different times, and because of the large demands of its great cooperative marketing organizations. The country branches have the same loaning power as the head offices in San Francisco and Los Angeles, and can make just as large loans to cotton growers in the Imperial Valley, to citrus growers in the southern counties, or to rice growers in the Sacramento Valley as to the merchants in the big cities. The independent unit banks have been frequently unable to meet the demands of the growers ...

cooperative organizations, and have suffered from inability to spread their risks. A unit bank in a citrus growing territory may fail because an untimely frost has destroyed a large part of the crop, but the losses of a branch bank in similar territory are easily absorbed because of gains in other territory.

The dangers of independent unit banking in one crop territory are well illustrated by present conditions in the northwestern spring wheat states. There have been about 400 bank failures in the Ninth Federal Reserve District since August 14, 1920, a large proportion of them having occurred during the present year and many of them since the harvest of the present year. Hugh McCullogh, the first Comptroller of the Currency, declared that all bank failures are fraudulent and that in every case the bank's officers should be prosecuted. Such an extreme statement might have much justification, if banks always had a fair change for success, but these failures in the spring wheat territory are an inevitable result of a faulty banking system. The effort to diffuse banking facilities among the people in sparsely settled agricultural states by the multiplication of small independent banks has broken down. Its failure has been more disastrous in the spring wheat territory than elsewhere, but it has been a failure nevertheless throughout the great agricultural sections of the middle west. More than one thousand banks have failed in the United States in the past three years, a record which, it seems to me, is a disgrace to a great commercial country, especially as nearly all of these failures have been small banks in agricultural states, where the losses have caused the greatest distress.

The effort to bolster up the system of small independent state banks through deposit guarantee funds has proven a failure. Oklahoma, the pioneer in this interesting experiment, has definitely abandoned it during the past year, and in several other states the guarantee funds have long been practically bankrupt. Doubtless the Federal Reserve System was expected by some enthusiasts to function as a sort of deposit guarantee fund, but the experience of the past three years has shown that you cannot save a small institution which has all its resources invested in eggs carried in one basket by lending it money, if the basket happens to drop and break the eggs, and that is exactly what happens to the small bank in a one-crop neighborhood when the crop fails.

A last effort might be made to safeguard the small banks in agricultural states by limiting the amount of their loans to one industry. National banking laws, and most state laws, have long recognized the danger of loaning too large a proportion of a bank's resources to one individual, firm or corporation, but have not yet recognized the fact that exactly the same risk is involved in loaning all or the greater part of a bank's funds to one industry. If banking facilities are going to continue to be extended to neighborhoods solely dependent upon wheat or cotton by means of small independent unit banks with reasonable safety such banks must be prohibited from loaning more than a safe proportion of their funds to wheat or cotton growers even though their deposits come wholly from such growers. Such a law would require that a considerable portion of the deposits of the people in such neighborhoods must be sent away from home for investment. It doesn't seem likely that Congress or any legislature would enact such a law.

There remains then only one method of diffusing banking facilities among the people in sparsely settled communities - the method advocated by Dunbar in 1892, carefully guarded branch banking. It has been proven successful in other countries and California has done much to prove its success in this country. It spreads banking facilities among the people much more widely than is possible even with our small unstable banking units. Canada has more than 4,000 banks, or banking offices, with a population of less than 10,000,000. If we had as many in the United States in proportion to population we should have 40,000, instead of 30,000 banks. Our people are therefore short twenty-five per cent of the banking facilities they might well have under a better system.

Nor is that all. The overhead expenses of the independent banking system of the United States are inordinately high, and the small independent banks in agricultural states are forced to pay too much to obtain deposits. This inevitably results in high interest rates in communities where money is naturally scarce and the demands high, and in low interest rates in the money centres. In short, popularly expressed, our system makes for cheap money in Wall Street and dear money in the agricultural states, and the queer part of it is that the West or Middle West seems to like to have it so. The chief opposition to branch banking comes from the very sections which would be most benefitted by adopting it. At some time in the not distant future, it seems to me, the farmers of the Middle West, from which California was settled, are going to ask why it is that they in an older community have to pay higher interest rates than the farmers of California pay, and also have to run greater risk of having their deposits lost or tied up in closed banks.

In Dunbar's remarks of 1892, he says "if the multiplication of branches were once fairly recognized <u>again</u> in the United States as a natural method, as it has been in the past," etc. The italics are mine. Branch banking is not new in the United States. It was generally recognized as natural before the Civil War, and was more generally developed in the West and South, which needed it most, than in the East. Indiana, Ohio, Iowa, Kentucky, Missouri, and several other states at the time of the outbreak of the war had established after many vicissitudes, sound branch banking systems. The State Bank of Indiana had as its President Hugh McCullough, who became the first Comptroller of the Currency. Hepburn in his "History of Currency in the United States" calls this institution "a model bank in every respect" and adds "It is an exemplary illustration of the efficacy of branch banking as a system". The banks of those days were all note-issuing banks. Deposit banking had not yet come into its own, though making progress in the big cities. It has been said that notes of the Bank of Indiana and of the Bank of Ohio were just as good as national bank notes and might be in existance today if they had not been forced out of existance by the 10 per cent tax that came into effect in 1866.

How did it come about that branch banking, though common throughout most of the West and South was excluded from, or at least not distinctly authorized in the National Banking Act? The explanation is to be found in the fact that New York and some New England States prohibited branch banking, and the New York free banking act as amended in 1848 was the model for the National Banking Act - in fact whole sections of the New York law were simply copied in the federal act. It is significant, however, that the prohibition of branch banking was not copied, and the Act was amended in 1865 so as to allow state banks to be nationalized and retain their branches.

None of the large western systems took advantage of this provision, but some small banks did, and there are today a few national banks with branches dating back to the early days of the National Banking system, notably a couple of national banks in Camden, N. J., which maintain branches in Philadelphia. Apart from the national banks which have recently acquired branches by absorbing state banks with branches in some of the large cities, there are in several states national banks which maintain branches similarly acquired beyond city limits. One such system with nine branches, all outside of the city of the parent bank, and covering several parishes, is in successful operation in Louisiana.

Space will not permit a discussion of chain banking, a device for getting around the laws against branch banking that has been very widely used in the West and South. No comprehensive study of chain banking in this country has ever been made, I think, but sufficient information is at hand to show that thousands of the small banks, including some of the same banks whose officers vote for resolutions denouncing branch banking at meetings of the American Bankers' Association, are not really independent banks. They are separately incorporated but are controlled in chains or systems by holding companies or by individuals. Probably the largest system of chain banks is the so-called Withem chain, comprising over 200 small banks, some of them national banks, controlled from Athens, Georgia. The Middle West and the South, and the Mountain states of the far West are full of such chains of banks. Such a wide-spread development could not have arisen without some strong economic demand. It proves the necessity of some kind of branch banking. Such evidence as there is seems to show that the chain banks while sometimes in trouble are on the whole rather better managed than independent banks of the same size and in similar territory. Chain banking may be defined as branch banking without the responsibilites of branch banking and with only a few of the advantages. The loaning power of each bank in a chain is only that of a small independent bank. They obtain some advantage through unified management, often by able bankers, and obtain some spread of risk by swapping paper among themselves. On the other hand they have not the opportunities for applying banking capital according to the unequal and variable needs of the different sections served possessed by real branch banking systems, and they have some special weakness of structure. A chain is only as strong as its weakest link, and generally when one bank in a chain fails the others also go down. Chain banking is at best but a clumsy and inefficient substitute for branch banking.

In conclusion I shall quote a few words written by J. Laurence Laughlin in 1912, at a time when he was professor of Political Economy at Chicago University, chairman of the executive committee of the National Citizens League and very active in the preliminary work that led to the passage of the Federal Reserve Act. "At present there seems to be little chance that the establishment of branches will be permitted. This means that there will be a permanent retention of conditions in which many very small banks must exist in order to meet the needs of the communities they serve, and in which there will be no direct control by one institution, or group of institutions, over another. The maintenance of such conditions <u>necessarily involves some rather serious suffering</u>." The italics are mine.

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