The Case for Interstate Branch Banking

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When asked about the most important developments in banking in the decade of the 1980s, most people are likely to point to the thrift debacle or to losses on loans to less developed countries. But arguably more influential has been a benign development, namely, the rise of interstate banking. In 1980, only Maine allowed bank holding companies from outside the state to acquire Maine banks. By 1990, all but four states allowed out-of-state banks to enter, although in many states there were regional limitations on entry.

Also during the 1980s, most (but not all) states relaxed their restrictions on branch banking, culminating a century-long trend toward liberalization. One hundred years ago, virtually all banking in the United States took place through unit banks, that is, independent banks with no branches. In the first half of the twentieth century, banks began to branch extensively within the cities in which they were headquartered; by the second half of the century, statewide branching networks or holding companies had became the norm in many states. In 1980, twelve states prohibited bank branching while twentyone allowed statewide branching. By 1990, only two states prohibited branching had grown to thirty-six.

The parallel rapid growth of interstate bank holding companies and liberalization of state branching laws suggest the next step: interstate branch banking. While the current practice of expanding across state lines by acquiring an existing bank and making it a subsidiary of the acquiring company differs little in practice from branching, it does entail some costs that could be eliminated by allowing the acquirer to turn a bank into a branch. Indeed, most bank holding companies that have been allowed to consolidate their subsidiaries within a state into a branch network have chosen to do so. And if banks are allowed to expand by setting up de novo branches in other states, then the potential for competition should be enhanced even further.

This article attempts to show that interstate branching, while not in demand in the past, is a logical and feasible step in the evolution of the geographical structure of American banking.¹ As a preliminary, it describes the current regulatory environment with regard to interstate branching, as well as the evolution of attitudes toward and regulation of branch banking. Given this background, the article outlines the arguments for interstate branching and then discusses ways it could be implemented, the likelihood of its adoption, and its possible effects on bank structure in the United States.

THE CURRENT REGULATORY ENVIRONMENT

Unique among American businesses, banks in the United States are regulated by an interrelated set of state and federal laws as to where they can conduct business. A bank may choose to be chartered by the federal government, in which case it is called a national bank and supervised by the Comptroller of the Currency. Alternatively, it may choose a state charter. If it chooses a state charter it is supervised by its state agency, as well as by either the Federal Reserve if the bank opts to be a Federal Reserve System member, or the Federal Deposit Insurance Corporation if it does not choose Fed membership. But whether a bank chooses a federal or a state charter, its geographical expansion is effectively regulated by the states.

At the state level, banks are generally chartered to operate within the state. In addition, most states specifically forbid entry through branching, although some states have the option to approve an out-ofstate bank's establishing a branch within their borders under specified conditions. Specifically, Montana, Nevada, New York, Oregon, Rhode Island, Utah,

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¹ The Federal Reserve has recently gone on record as supporting changing current law to allow interstate branching (Greenspan 1990).

and Virginia might permit entry through branching (unpublished survey, Conference of State Banking Supervisors, 1990).²

At the federal level, the McFadden Act of 1927 (as amended in 1933) states that national banks:

may, with the approval of the Comptroller of the Currency, establish and operate new branches . . . at any point within the State in which said association is situated, if such establishment and operation are at the time authorized to State banks by the statute law of the State in question by language specifically granting such authority affirmatively and not merely by implication or recognition, and subject to the restrictions as to location imposed by the law of the State on State banks. (12 U.S.C. Section 36(c))

In general, McFadden gives national banks the right to branch to the same extent that state banks are permitted to branch. But even if a state were to allow interstate branching for state-chartered banks, it is not clear whether national banks could be given interstate branching authority under current law because the law contains the phrase "within the State", which would appear to limit national banks to within state boundaries. Thus McFadden is usually interpreted as prohibiting interstate branching by national banks.³

Whatever the specifics of how banks are restricted from branching across state lines, virtually all interstate bank expansion to date has taken place through bank holding companies. The Douglas Amendment to the Bank Holding Company Act of 1956 forbids interstate acquisitions by bank holding companies unless the acquired bank's home state allows the acquisition. Under current state interstate banking laws and the Douglas Amendment, a bank holding company now expands interstate by acquiring a bank or bank holding company and then operating it as a subsidiary rather than a branch. For example, a bank holding company headquartered in Virginia and engaging in full-service banking in Maryland and the District of Columbia must under current law operate through three separate banking organizations, one for each jurisdiction.

One prominent wrinkle present in most but not all interstate banking laws is a ban on expansion by

creating a de novo subsidiary. That is, most interstate banking statutes allow entry only by acquiring a bank that has been in existence a specified number of years. It is reasonable to assume such restrictions were necessary to secure the passage of interstate banking laws by making the laws more palatable to potential acquirees. Foreclosing the option of de novo entry removed an alternative to entry by acquisition and thereby raised premiums paid by entrants for banks. While it is likely that most banks look first at acquiring an existing depository institution, blocking de novo entry means that entrants are deprived of an option they might exercise if merger premiums seemed excessive or if no existing bank in an otherwise attractive market were a suitable candidate for takeover.

Thrift institutions already have the legal authority to branch interstate, although the authority has been restricted by regulators. In Independent Bankers Association of America v. Federal Home Loan Bank Board (557 F. Supp. 23 (1982)), the District Court ruled that branching by federally chartered thrifts comes under the authority of the Federal Home Loan Bank Board (now the Office of Thrift Supervision), whether intrastate or interstate. The Independent Bankers challenged the Home Loan Bank Board when it adopted a doctrine of allowing interstate branching to acquire a troubled thrift and then allowing branching within the acquired thrift's state. The court made clear that restrictions on interstate thrift branching are administrative rules and not enshrined in the law as is the case with banks. The implication is that the rules could be modified at the discretion of the Office of Thrift Supervision without any change in the law.

There are a few interstate bank branches operating today that had been established before either state or federal laws forbade them. For example, since 1905 the Bank of California has operated branches in Portland, Oregon, and Seattle and Tacoma, Washington. All three were acquired from the British bank that had originally established them. In addition, Midlantic National Bank in New Jersey operates a branch across the Delaware River in Philadelphia. Since both Bank of California and Midlantic are federally chartered, there is no problem with state regulatory authority over the branches. More recently, after the Bank of America acquired a failed Arizona thrift that had operated a branch in Utah, the Utah banking regulators allowed Bank of America to continue to operate the office as a branch.

² Massachusetts allowed entry through branching in its 1983 regional interstate banking law. In September 1990, the regional law was superseded by a nationwide interstate banking law. The new law does not permit entry through branching.

³ One could also argue that McFadden was intended to give national banks branching parity with state banks. If so, federal regulators might have the discretion to allow national banks to branch across state lines along with their state-chartered brethren (Eckland, Olsen, and Kurucza 1990).

There have been other examples of interstate branch banking (Federal Reserve Board 1933a, pp.207-9). The First and Second Banks of the United States both had branches during their existence. Wells Fargo and Company operated branches outside California. The branches were closed apparently as the result of business decisions and not of legal or regulatory actions. Finally, in 1874 the Freedman's Savings and Trust Company, chartered by Congress, had branches in all the Southern states and one in New York (Chapman and Westerfield 1942). Still, given the number of banks in the United States, it is striking to see how little interstate branching had occurred even before it was explicitly banned.

THE ORIGINS OF CURRENT LAW

The history of banking in the United States is characterized not simply by the lack of interstate branching, but by the longtime lack of interest in branching within a state as well. That is, while branching has occurred throughout American banking history, it only caught on as a widespread phenomenon in the twentieth century, and then only in fits and starts. In contrast, the history of Canadian banking has included branch banking from the start and there have apparently been no serious efforts to emulate the American system. And while in Canada a small number of commercial banks with extensive branch networks have been able to serve the market, in the United States small independent banks abound even in states with no restrictions on branching.

Before the Civil War, there was branching at both the federal and state levels (Federal Reserve Board 1933a). At the federal level, the First Bank of the United States, which lasted from 1792 to 1811, was headquartered in Philadelphia and maintained offices in eight other cities. The Second Bank of the United States, which lasted from 1816 to 1836 and also operated out of Philadelphia, had as many as twentyfive other offices during its life.

In addition, there were state branch banking systems, although most of the branches that survived into the National Bank era after the Civil War ended up incorporating as independent national banks. Finally, "free banking" arose in the North at the same time as branch banking in other states. Free banking meant that specific legislative chartering of a bank was not required; instead, anyone meeting specified requirements (such as initial capitalization and depositing bonds with the chartering state) would be issued a charter. Free banks were unit banks; they had no branches, although branch banking was not specifically forbidden.

The last category, free banking, turned out to be significant for the future of branch banking law because the New York free banking law contained provisions specifying that "the usual business of banking . . . shall be transacted at the place where such banking association . . . shall be located . . ." (Federal Reserve Board 1933a). The language was apparently not aimed at branch banking per se, but at the then notorious practice of issuing currency at the bank's main location, usually in a remote area ("wildcat banking"), but only redeeming at a discount in a city location. The provisions were significant because they were later to be incorporated into the National Banking Act and still later to be interpreted as forbidding branching by national banks, even though there is no evidence that doing so was the original intent of the legislation (Fischer and Golembe 1976).

When the National Bank System was established at the end of the Civil War, the new system was comprised entirely by unit banks, even though statechartered branch banks were specifically allowed to keep their branches if they converted to national charter. As it turned out, the grandfathering authority for branches was not used until the first decade of the twentieth century. The important point is that branching was simply[®] not an important issue, not because of specific opposition to it but because of lack of interest. Apparently unit banks had a comparative advantage over branch banks.

The first stirrings of renewed interest in branch banking came during the late 1890s in the form of proposals to encourage branching by national banks as a means of making banking services available to rural areas that could not support a separately incorporated bank (Comptroller of the Currency 1895). While such proposals did not elicit much interest from the public, bankers were largely opposed so none were enacted. Instead, in the Currency Act of 1900 the required capital for establishing a national bank was reduced from \$50,000 to \$25,000 (or, in 1990 dollars, from \$663,500 to \$331,750) for towns with population of less than 3,000.⁴

⁴ In comparison, in 1990 the minimum initial capital for a national bank was \$50,000 in a town of less than 6,000 inhabitants, \$100,000 for a town of up to 50,000, and \$200,000 for a city of over 50,000 (12 U.S.C. 51). In practice, all regulatory agencies have administratively adopted far higher minimums.

The result was, predictably, an increase in the number of banks in the United States from approximately 13,000 in 1900 to about 25,000 in 1910 (Board of Governors 1959). And of the new banks, about two-thirds were small unit banks with an average capital base of just over \$25,000 (Chapman and Westerfield 1942). The resultant proliferation of independent unit banks made for an anti-branching force that slowed the growth of branch banking for decades.

While the number of unit banks increased, branch banking became more common at the state level. In California, branch banking started as a largely rural phenomenon, especially after branching was officially approved for state banks in 1909 (Federal Reserve Board 1933b). But in the rest of the country, branching became commonplace not in rural areas but within cities, in particular, in New York, Detroit, Philadelphia, Boston, and Cleveland.

As both branching by state banks and the number of unit banks grew, it is not surprising that unit bankers attempted to contain the spread of branch banking. The result was, first, a flurry of laws in the 1920s to ban branch banking, mostly in states where it did not yet exist. As shown in Table I, more states banned branching in 1929 than had done so in 1910. Second, there were moves to keep national banks from branching at all, with the avowed purpose of stemming the spread of branch banking in any form.

National banks in branching states wanted the same branching privileges as their state-chartered brethren. But unit banks were adamant in opposing any extension of branch banking. Further, the money center banks of the day were largely opposed to branch banking, since they stood to profit from correspondent business and were not much interested in retail customers. And apparently absent from the debate was any consideration of interstate branching.

Regulatory policy toward branch banking varied over time. In 1911, the Comptroller requested that the Attorney General issue an opinion regarding branching by national banks. Based on the language originally adopted from the free banking statutes, the Attorney General opined that national banks were not allowed to branch. But by the early 1920s, the Comptroller allowed branching in order to meet competition by state-chartered banks in branching states. Indeed, one Comptroller believed he could allow branching regardless of state laws, but simply followed state laws as a matter of policy, just as did the Federal Home Loan Bank Board in the 1980s.

Table I

STATE BRANCHING LAWS, SELECTED YEARS

Alabama Alaska Arizona Arkansas California Colorado	1910	29 • — •	39 ♦ — ■	61 ♦	7.9. ♦ ■ :	
Alaska Arizona Arkansas California		•	♦ ¹	•	_	+
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Arkansas California			•			
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Idaho		•				
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Indiana		•	•	•	•	•
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Kansas		•	•	•	•	ġ
Kentucky				•	•	
Louisiana	•	•	•		•	
Maine	•	•			É.	
Maryland						
Massachusetts	٠	•	•		•	
Michigan				•	•	
Minnesota			٠	•	•	•
Mississippi	. •	. 🔶 .	•	•	•	
Missouri	٠	٠	•	•	•	•
Montana		•	• •	•	•	•
Nebraska		•	•	•	•	. 🔶
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New Hampshire				, ·	•	
New Jersey		•	•	•		
New Mexico	-	÷	•	•	•	٠
New York	•	•	•	•		
North Carolina						
North Dakota			•	٠	•	
Ohio		•	•	•	•	
Oklahoma				•	٠	
Oregon		•				
Pennsylvania	<u>.</u>	<u>•</u>	<u>+</u>	. 🔶 🛛	•	
Rhode Island						
South Carolina						
South Dakota						
Tennessee		•	•	•	•	
Texas	•	•	<u>.</u>	•	•	
Utah		•				
Vermont						
Virginia	-			<u>+</u>		
Washington		•				
West Virginia		٠	. •	ب ا	•	
Wisconsin	•	٠	•	•	•	<u>•</u>
Wyoming						

Sources: Chapman and Westerfield 1942; Federal Reserve Bulletin 1933, 1939; Federal Reserve Board 1933a; White 1976; Department of the Treasury 1981; Banking Expansion Reporter, August 6, 1990.

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Finally, in 1924 in *First National Bank in St. Louis* v. *State of Missouri* (263 U.S. 640), the Supreme Court held that a state had the right to enforce its branching restrictions for national banks unless Congress specifically said otherwise. The Court also held that national banks did not have the right to branch.

The matter was put to rest by the McFadden Act of 1927, passed after three years of intense debate. The Act allowed a national bank to branch within its city boundaries if state banks were allowed the same or more liberal privileges. Since most branching at the time was within cities, the Act probably was sufficient for most banks. But in California, the restrictions were binding on national banks so they led to forms of corporate organization and affiliation that served to evade the Act's restrictions (Federal Reserve Board 1933b).

Following the McFadden Act, anti-branching sentiment waned, largely because the extensive bank failures of the late 1920s and early 1930s showed the weakness of unit banking and made branching attractive as a means of making failures less likely. As Table I shows, the consequence was that between 1929 and 1939 the number of states prohibiting branches fell sharply while the number permitting statewide branching doubled.

While the ultimate result of the rash of bank failures was deposit insurance rather than significantly enhanced branching powers (Fischer and Golembe 1976), there arose during this time the first explicit support for interstate branching. Senator Carter Glass of Virginia, an architect of the Federal Reserve Act, proposed in 1932 a bill that would liberalize national bank branching powers. In particular, the bill proposed not simply statewide branching for national banks but "trade area" branching as well. That is, a bank located near a state line with frequent business in the other state would be allowed to branch up to fifty miles into the state. An obvious example of such a trade area is the Washington, D.C., metropolitan area.

The Glass Bill was not enacted. Instead, the Banking Act of 1933 (better known as the Glass-Steagall Act) liberalized the 1927 McFadden provisions to permit national banks to branch to the same extent as was permitted to state banks. Thus national and state banks had approximately the same branching powers, and the law remains in force today.

Since 1933, virtually all the action on branch banking has occurred at the state level, although most changes since the Depression era occurred during the 1980s. Table I shows how the laws have changed over time for the individual states. In 1939, eighteen states allowed statewide branching while nine allowed only unit banks. By 1979, the number of states allowing statewide branching and the number allowing only unit banking had both grown by three. As of 1990, thirty-six states allowed statewide branching while only two states prohibited branching altogether. But as mentioned earlier, by this time all but four states had enacted laws permitting interstate expansion by holding company acquisitions. Thus the question is no longer whether banks should be allowed to expand interstate, but rather whether they should be allowed to do so by branching.

ADVANTAGES OF INTERSTATE BRANCH BANKING

Safety

From the point of view of the banking system, interstate branching would be beneficial in that it would enhance safety. In general, the historical record supports the assertion that branch banks have a better safety record than unit banks. In particular, during the 1920s and early 1930s the failure rate was inversely related to bank size (Cartinhour 1931; Chapman and Westerfield 1942). Further, during the period 1921-31, the failure rate as a percentage of banks operating at the end of 1931 was 46.5 percent for all banks but only 26.4 percent for banks with branches (Federal Reserve Board 1933a, 1933c). But the comparison understates the difference since the majority of branch banks that failed had only one branch. For banks with over ten branches, the failure rate was only 12.5 percent (Federal Reserve Board 1933a).

There are several related reasons for the better safety record of branch banks, reasons that apply *a fortiori* to interstate branching. First, by its very nature, a system of small unit banks is more prone to insolvencies if funds move out of a troubled unit bank serving an area than would a system of branch banks in which funds simply flowed out of a troubled branch serving the same area (Greenspan 1990). That is, events that for a unit bank would lead to insolvency might simply lead to a loss for a branch serving the same area. Second, runs are more likely in a system of small banks, since small, localized shocks are more likely to be perceived as threatening entire institutions (Calomiris 1990).

The first two reasons for branch banking's greater safety imply the third: geographical diversification. By making it less costly for banks to expand across state lines, interstate branching would make it possible for them to diversify their loan portfolios to a greater extent than is now possible. Banks would consequently be less subject to swings in regional economies such as agricultural failures or declines in regional industries, so what could mean insolvency for a geographically restricted set of banks might mean only losses for one part of a geographically diversified bank. A fourth reason for greater safety is that a branch bank in essence serves as a mutual loss sharing arrangement under which losses to one part of a bank's operation are diffused across the entire organization. Again, geographically limited losses that for a geographically limited bank might mean insolvency could be more easily absorbed by a larger, geographically dispersed organization.

Finally, interstate branching would make it less costly to gather core deposits, which by definition are a more stable funding source than purchased funds. Despite their stated maturity of zero, core deposits can have effective maturities of several years (Flannery and James 1984). So by making core deposits cheaper relative to purchased funds, interstate branching could help increase the duration of a bank's liability side so the bank would be less vulnerable to interest rate swings than if it relied heavily on purchased funds.

There would be an incidental safety benefit to interstate branching. The Federal Reserve has promulgated the "source of strength" doctrine, which calls upon a bank holding company to support its subsidiary banks in times of adversity. There have been recent cases in which a bank holding company, when looked at as a consolidated entity, was insolvent even though some subsidiary banks were technically solvent on their own (*MCorp v. Board of Governors of the Federal Reserve System*, No. 89-2816, 5th Cir., May 15, 1990). Problems arose because of disagreements as to the legal obligations between a bank holding company and its subsidiary banks, each of which was a distinct legal entity.

If the entities involved had been branches rather than subsidiaries, such problems might not have arisen (unless assets had been moved into nonbank subsidiaries). While in the case of MCorp the reason for the separate subsidiary banks was state law and not the McFadden Act, the case does serve to illustrate the problems that can arise with organizations comprised by separately chartered banks. If in the future an interstate bank holding company were to face insolvency, disputes such as those arising with MCorp would be far less likely if regulators were dealing with one consolidated bank rather than a web of subsidiary banks.

Consumer Benefits

From the point of view of the consumer, a major advantage of interstate branching over the current system would be convenience. For example, suppose a bank holding company has subsidiary banks in, say, Virginia and Washington, D.C. A customer with an account at the Virginia bank might be allowed to cash a check at an office of the Washington bank, but not to make a deposit. That is, full service banking across state lines simply does not yet exist. In contrast, if the subsidiaries were branches a customer could do at an out-of-state branch everything she could do at a branch in her own state.

In addition, an interstate branch network would be beneficial to travelers needing cash and banking services. While such innovations as travelers' checks and credit cards have developed to lessen the inefficiencies associated with the current banking system, the availability of banking services over a wider area would add to the traveler's options. Finally, by adding to the number of banks able to branch into a market, interstate branching might increase the accessibility of banking services. Just as statewide branching has made banking services more available to consumers than under unit banking, so should interstate branching compared with the current balkanized system (Evanoff 1988).

Efficiency

From the point of view of a bank interested in operating interstate, a major argument for allowing interstate branching is efficiency. Under the current system of allowing interstate expansion only through bank holding company subsidiaries, a bank must incur parallel costs in each state in which it chooses to operate. First, each subsidiary must have a separate board of directors as well as committees associated with each board. Second, each subsidiary must submit separate regulatory reports (for example, call reports) and undergo separate examinations. Third, each subsidiary must submit its own audited financial statement. Fourth, each subsidiary requires its own support and control functions, for example, personnel, budget, audit, and accounting, that for a branch network could be consolidated. Finally, each subsidiary will maintain its own computer systems and applications for such tasks as demand deposit accounting, loans, and reserves. Even if the bank holding company is managed as if it were one bank,

the requirement that each subsidiary report separately prevents the systems from being integrated completely.

Duplication is not the only source of costs in a network of subsidiaries. Each subsidiary will have to satisfy capital requirements, so there are costs associated with the complex treasury exercise of balancing capital between the subsidiaries. Further, costs incurred by the parent company must be allocated among the subsidiaries, even though there may be no economically meaningful way of allocating such costs. That is, certain costs originating in, say, the lead bank for the benefit of the subsidiaries cannot be assigned to the subsidiaries except by some unavoidably arbitrary method. Finally, since each subsidiary is a separately chartered bank, moving assets between entities must take place on an "arm's length" basis, meaning that internal transfers must be treated as if the subs were not united by common ownership. As a result, internal transactions might have tax considerations and other costs that would not arise if the subsidiaries were consolidated.

Despite the costs of maintaining separate subsidiaries, a bank holding company choosing to consolidate will lose at least four benefits of separation. First, boards of directors can be a source of referrals for loans and other business for a bank in a local area. a source that would be lost if subsidiaries were converted to branches. Second, if a bank holding company purchases a bank that had served an area competently and profitably for years, the company might prefer to preserve the "brand name capital" of the acquired bank by letting it operate as a subsidiary under its old identity instead of under the name of the acquirer. Third, unlike their Canadian counterparts, American bankers do not have experience in managing far-flung branch networks, so decentralized management might compensate for this lack. The problem should lessen over time, however, as bank holding companies develop experience in interstate operations and develop the ability to centrally manage more geographically dispersed branch networks.

Finally, a bank holding company might stay decentralized to preserve the benefit of tiered reserve requirements. When calculating the reserves a bank is required to maintain on its transactions accounts, the required ratio of reserve balances to deposits increases as follows: The first \$3.4 million of its transactions accounts is exempt from any requirements; the required ratio is 3 percent for \$3.5 million to \$40.4 million of transactions accounts; and the ratio is 12 percent for all remaining transactions accounts over \$40.5 million (*Federal Reserve Bulletin*, August 1990). Since the cost of reserves is the foregone interest on the funds, a bank holding company could hold down its required reserves by expanding by means of small subsidiaries rather than branches.

Thus there is a tradeoff between costs and benefits of maintaining separate subsidiaries. As a decentralized bank holding company grows and expands the number of subsidiaries, one would expect the costs of decentralization enumerated above to rise. At the same time, at least one benefit, the lower amount of interest foregone on reserves, becomes less significant to a banking organization as it grows larger. For example, the deposits subject to the lower requirements would be 4 percent of assets for a bank with assets of \$1 billion but only 0.4 percent of assets for a bank with assets of \$10 billion. Thus, other things equal one would expect consolidation to become more likely as an organization increases in size.

Payment Processing

One of the most obvious places for improvements in efficiency lies in the payment system area. For example, consolidating a set of holding companies into a branch network would increase the number of "on-us" checks, that is, checks for which the payer and payee both hold accounts in the same bank. If so, then more clearing could take place internally (Berger and Humphrey 1988). In addition, converting interstate subsidiaries will enable a bank to consolidate the reserve accounts of its subsidiaries into one account. Since banks use reserve accounts to clear payments, there would be lower administrative costs associated with payment processing. Indeed, even under the current system some bank holding companies have chosen to process all their Fedwire payments through one account regardless of which state subsidiary they involve. Such a practice would likely become automatic under interstate branching.

Competition and Credit Availability

From the point of view of both banks and consumers, a major result of interstate branching would be increased competition, especially if banks could branch de novo. Since allowing interstate branching would make it less costly to enter a state, banks would be more likely to enter to take advantage of profitable lending opportunities. This would have at least two effects. First, it would increase the number of competitors (or potential competitors) in a market. Second, it could make more and cheaper credit available to a market.

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With regard to availability of credit, opponents of interstate branching (and for that matter of branching in any form) repeatedly point to the possibility that branch managers are less concerned with the local economy than are owners and managers of the bank, so a branch would simply siphon funds out of an area to be lent elsewhere. But such possibilities already exist for banks as well as branches. For example, a bank not wishing to lend in an area could sell federal funds upstream to a correspondent bank, or could put its funds into investment securities rather than loans.

Further, a branch that ignores profitable lending opportunities will be vulnerable to competition from local institutions. Finally, the argument that branches suck credit out of a region is a two-edged sword: The ability to draw credit out of an area implies the ability to inject credit into an area, so branches may be as likely to bring funds into an area as to take them out. But regardless of whether objections to branching on the basis of credit availability have any validity, such problems, to the extent they exist, can be more directly attacked through the Community Reinvestment Act than through branching statutes.

MODELS OF INTERSTATE BANKING

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The United States follows a dual banking system, which means that banks may be chartered either federally or by the states. When developing a plan for interstate branching, one must be cognizant of the interaction of state and federal laws regarding banking structure. The following paragraphs describe three possible means of implementing interstate branching.

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National Bank Branching

Interstate branching could be instituted by simply allowing federally chartered banks to establish branches without regard to the laws of the states in which the branches would be located. That is, the national bank system would become a national banking system in the sense of a nationwide system and not simply a federally chartered one. Such a system could be put into place by repealing the McFadden Act and changing the language of current law to grant a national bank the authority to establish branches freely without regard to state laws. The main requirement would be specific Congressional authorization. The advantage of using the national bank system to bring about interstate branching is that it would be relatively simple. That is, it could be accomplished through federal legislation and would not require consent at the individual state level. Further, the approach would not involve overlapping or conflicting regulatory agencies, since all national banks are supervised by the Office of the Comptroller of the Currency. Such a system is already in place in Canada, where bank chartering and regulation have been federal functions since the British North America Act of 1867.

The disadvantage of the national bank approach to interstate branching is that it would put statechartered banks at a competitive disadvantage to national banks, at least in those states that do not grant interstate branching privileges to state-chartered banks. Within the Federal Reserve System, there would be an additional problem: All national banks are members of the Federal Reserve System, but state-chartered banks may elect to join or not to join the System. In a system of unlimited interstate branching by national banks, there would be a disparity between the powers of national banks and state member banks. Of course, there would be a simple solution: States could grant interstate branching powers to the banks they charter.

Host-State Regulation

The first alternative concerns itself only with national banks, and in effect overrides any state powers over national bank expansion. An alternative that preserves the authority of the states would be to permit state-chartered banks to branch interstate provided they abide by the regulations of the state into which the bank wishes to expand. Such an alternative would most likely retain state authority over bank structure by allowing national banks to enter a state only if the state consents.

Utah in effect agreed to a scheme of host-state regulation when, as previously mentioned, it permitted a state-chartered bank in Arizona to maintain a Utah office as a branch. The Arizona bank had previously been a thrift, which was taken over by the Resolution Trust Corporation, then purchased by BankAmerica Corp., and then converted to a state-chartered commercial bank (*American Banker*, July 12, 1990). Consistent with thrifts' more liberal interstate branching powers, the thrift had operated a branch in Utah. When BankAmerica converted the thrift to a bank, however, it had to seek permission from Utah to continue to operate the office as a branch instead of convert it to a subsidiary. Utah assented, and under the agreement Utah will be responsible for examining the branch (American Banker, September 4, 1990).

Leggett (1989) has put forward a more comprehensive proposal involving host-state regulation of interstate branching. The proposal would allow bank holding companies with interstate subsidiaries to consolidate their banks as branches. It belongs in the host-state taxonomy because a branch of a statechartered bank could not exercise any powers in the host state that were not granted to banks chartered in that state, although the proposal also provides that the out-of-state branch could not exercise any powers not granted by its home state. While the state bank's own regulators would examine the entire bank, they would be required to apply the host state's laws and standards for out-of-state branching applications. In order to ensure that such laws and standards are followed, the host-state regulator would have the authority to approve or disapprove applications for entry.

There has been legislation recently introduced in Congress that follows the host-state regulation principle (H.R. 5384 and S. 2922). The bills would (1) repeal the Douglas Amendment to the Bank Holding Company Act; (2) amend the Federal Deposit Insurance Act to specifically authorize outof-state branches unless a state specifically forbids them; and (3) amend McFadden to allow establishment by national banks of out-of-state branches unless a state specifically forbids it as in (2). The activities allowed the branch would be governed by host-state law.

Since states would have the opportunity to pass laws that block interstate branching, it is not clear how far such a bill would go toward facilitating nationwide branch systems. Still, two points are significant. First, by repealing Douglas the bill would permit nationwide interstate banking by the holding company acquisition route, as well as eliminate all geographical restrictions on interstate entry. That alone is the most extensive nationwide banking initiative to arise at the federal level to date. Second, states would only be able to opt out of permitting interstate *branching*. And since states would be required to specifically pass laws that forbid interstate branching rather than laws that permit it, branching would be allowed if a state simply did nothing.

Home-State Regulation

A third alternative for interstate branch banking is based on an analogy with the European Community's Second Banking Directive, to take effect at the end of 1992 (Golembe 1989,1990). The effect of the Directive will be to create a "single banking license" for a depository institution in any European Community nation to provide banking services. The license is based on two concepts. The first is mutual recognition by each member country that every other country's laws and regulations are equal to its own and that no country will use its laws and regulations to restrict access to its market. The second is home country control, so even if laws and regulations differ between countries, those of the home country will govern the operations of a branch in another country (Key 1989). In certain areas such as consumer protection, however, host-state regulators retain authority.

As applied to the United States, the European Community approach would involve authorizing a bank chartered in one state to branch into any other state. Whatever the host state's laws, the branch would be governed by the laws of the state in which the parent bank is located. Thus within such a framework, a bank located in a state with statewide branching would be able to expand into a limited branching state but still branch throughout the state regardless of what the local banks could do. And to take the analogy further, if a bank located in a state that permits banks to sell life insurance branches into a state that does not, the branch would be able to exercise the more liberal insurance powers even within the restrictive state's boundaries.

There are advantages to both the host-state and home-state regulation alternatives. Given the dual banking tradition of the United States, host-state regulation is likely to be more consistent with current practice. That is, by deferring to host states it is less likely that states would oppose entry from another state than if control over the branch were to lie entirely in the home state. Further, even if hoststate regulation were the norm, there would be no reason why host states could not agree to defer in specific cases to home state regulators. In such an environment, host states would have the option rather than the obligation to accept another state's laws and regulations.

Home-state regulation would probably lead the laws and regulations of the various states to become more similar and consistent. Since banks in a restrictive state would be at a disadvantage relative to branches of banks from liberal states, there would arise pressure in the more restrictive states to loosen the rules. In the European Community, such a tendency toward "regulatory convergence" is fully expected to occur and is consistent with the goal of "harmonization" of rules, regulations, and standards between member countries (Key 1989).

Depending on one's views concerning the dual banking system, regulatory convergence may or may not be an advantage. If one believes that an advantage of the American dual banking system is that it fosters diversity and allows some states to experiment while others are more conservative, then regulatory convergence might be less attractive than it would be to one who considers the tension between state and federal regulation to be an obstacle to progress. More important, while convergence toward liberal branching laws among states would have salutary effects on safety, convergence toward, say, liberal real estate investment laws for banks might not.

INCENTIVES TO PERMIT INTERSTATE BRANCH BANKING

Having presented the case for interstate branching and outlined three ways it could be structured, the next matter for consideration is the likelihood of its adoption. As mentioned previously, many of the benefits of interstate branching will accrue to consumers in the form of convenience, increased competition for deposits, and more efficient payment clearing. But consumers are by their nature a diverse and unorganized group, and the benefits to any individual consumer are not likely to be so large as to excite him to lobby his state legislature to allow interstate bank subsidiaries to convert to branches. And while the experience of Utah in allowing an outof-state thrift branch to operate in the state as a bank branch suggests that sales of insolvent thrift institutions might require some loosening by states of restraints on entry by branching, it is not clear that such liberalization would be necessary in most states. Thus it is logical to ask: Whence will come the pressure for interstate branching?

As described earlier, interstate branching would be more efficient than maintaining separate subsidiaries. Banks with interstate operations might therefore be expected to support permitting interstate branching. But because it would make it less costly for a bank to move across a state line, interstate branching would likely increase the number of potential competitors in a market. Consequently, other (and probably most) banks at the state level might have incentives to oppose interstate branching, or at least to refrain from actively supporting it.

Further, competition could be even more intense if de novo interstate branching were permitted, since banks that are now deterred on the margin from expansion into another state by the merger premium cost of acquiring a bank might find it less costly to enter a state by establishing a new branch. In the past, interstate banking laws have been crafted in a way that limits competition. In particular, most states restrict de novo entry in favor of entry by acquisition, which tends to make merger premiums higher than would be the case were the de novo option available. Thus potential acquirees might have reasons to oppose permitting alternatives to entry by acquisition.

The lineup of potential winners and losers from interstate branching brings to mind the long opposition by unit bankers to branching within a state. In particular, it illustrates Anthony Downs's (1957) principle that when a small group has much to gain and a far larger group has about the same amount to lose from a specific measure, the gainers have the incentive to devote more resources to having the measure enacted than would the losers, each of which would stand to lose a small amount as individuals. The same idea was expressed by the Federal Reserve Board (1933a):

That the opposition of the bankers should have been overwhelming, in the absence of any real public interest in favor of branch banking, is not strange. Nor is it strange the bankers, pursuing, as in the main they were, a thriving and profitable business, should have been more moved by the probability that branching would affect them individually than by the possibility that the economic system as a whole would profit from it.

With regard to interstate branching today, the question is whether there exist the same incentives to fight it as there were to fight branching within a state in the first decades of this century.

At first glance, one might be pessimistic regarding the chances for interstate branching because of the relative influence of interstate and in-state banks on the state legislature. That is, in states with both types of banks, both will have influence on the legislature, and reform may in such a state originate in state legislation. But in states with banks that are not likely to expand into other states, legislative pressure might more likely be for protection rather than enhanced entry. Consequently, it might seem improbable that any large-scale initiative for interstate branching could originate at the state level. Still, it should be recalled that the current crop of interstate banking laws, that is, those that allow bank holding company expansion across state lines, did originate at the state level. While the prevalence of laws that block de novo entry probably reflects the incentives of potential acquirees to protect their interests, banks apparently did not see fit to devote a great deal of resources to blocking interstate banking in toto. Thus the success of efforts to introduce interstate banking suggests that incentives to oppose interstate branching are not as strong today as were the incentives in the 1920s to oppose branching.

Whatever the interplay of interests at the state level, the incentives might well be different at the federal level. While both regional interstate banks and those seeking to limit competition are wellrepresented, the balance is probably less tilted in favor of protection. In addition, the banking committees of both the House and Senate are by their nature more likely to reflect a national perspective than that of individual state interests, so public interest arguments might get a more sympathetic hearing. Finally, consumer interests (such as they exist) may be better represented at the federal level than in the legislatures of fifty states.

The upshot of incentives at both the state and federal levels seems to be as follows. It is probably more likely that interstate branching would be approved at the federal level than in the legislatures of all fifty states. Further, if Congress follows the H.R. 5384 approach of authorizing interstate branching unless states pass legislation specifically *forbidding* it, the result is likely to be interstate branching in more states than if it were left to the states to pass laws specifically *authorizing* it. The reason is that it is easier for either side to block legislation than to get it passed, since a law can be bottled up or killed in committee without ever getting it up for a vote.

There is some probability that branching laws in the United States could be liberalized in response to the developments in the European Community cited above. Prior to the adoption of the Second Banking Directive, there was some sentiment in the European Community in favor of adopting reciprocity, under which American banks would be allowed to do in the European Community whatever European Community banks could do in America. American banks preferred national treatment, under which American banks could do in Europe whatever European Community banks were allowed to do there (and similarly for EC banks in America). If reciprocity had been adopted, American banks might have come under severe restrictions relative to their European counterparts. In the end, national treatment prevailed, although there have been repeated urgings that American banking laws be reformed to give European banks the same access to the American market as American banks now have to the European market.⁵

EFFECTS ON BANK STRUCTURE

As of the end of June 1990, there were 12,321 banks operating in the United States. Because of mergers, consolidations, and failures, this number is widely expected to fall even if the current laws on branching remain in effect. Interstate branching may cause the number to fall still more. What is not clear is how much interstate branching will contribute to the fall in the number of banks.

The obvious candidates for consolidation are, of course, the bank subsidiaries of interstate bank holding companies. At the time of this writing there are 160 interstate bank holding companies operating at least 465 bank subsidiaries in different states. If the law is changed to allow interstate subsidiaries to be consolidated into branches, and assuming all interstate bank holding companies decide to consolidate, then the number of separately chartered banks in the United States could fall by at least 305. And assuming that regional restrictions on interstate banking are removed, the number could fall even more by means of end-to-end mergers between banks that had been restricted to separate regional compacts such as those in the Southeast and New England.

At the other end of the spectrum, in June 1990 there were 11,724 small banks, that is, banks with \$500 million of assets or less. The effect of interstate branching on small banks would largely depend on the laws of the various states. In states with restrictive branching laws, it is reasonable to assume that some banks have remained in business because of the laws and would be absorbed by another organization if the laws were liberalized. So if interstate branching were enacted in such a way as to either override state branching laws or to induce states to liberalize their branching restrictions, then the number of small banks would probably fall.

⁵ Such calls for reform routinely cite the McFadden Act as an obstacle to foreign bank expansion. See, for example, "Time to Open Non-EC Markets, Brittan Tells Bankers' Group," *BNA's Banking Report*, February 12, 1990; and "U.S. Urged to End Banking Barriers," *American Banker*, March 26, 1990.

But in states with liberal branching laws, there might be little if any effect on the number of small banks. For example, all states in the Fifth Federal Reserve District allow statewide branching. Table II shows there are substantial numbers of banks with \$500 million of assets or less in each of the Fifth District States. Except perhaps in West Virginia, which did not allow statewide branching until 1988, the number of small banks cannot be attributed to branching restrictions. The survival of small banks in such a legal environment suggests that the vast majority would remain in business even if interstate branching were permitted. To the extent that reductions in the number of small banks occur in states already permitting statewide branching, they are likely to be the result of acquisitions of banks in markets previously divided by state lines.

Another way to consider the probable effect of interstate branching is to take the number of banks per capita for countries with no limitations on branching and project the same ratio on the United States. Canada, for example, has eight major banks, of which six operate nationwide, serving its population of 26.3 million. If the United States had the same ratio of banks to population, it would have about 75 banks, of which about 56 would operate nationwide.

At first blush, 75 banks (much less 56) seems small compared with the current 12,321. But 56 banks competing with each other in markets across the United States does not seem small, especially when one realizes that the vast majority of American banks operate in one market. Only if the 56 banks operated in separate, balkanized markets would there be cause for concern. More important, even if most of the 12,321 were to cease to exist as separate firms, they would not simply vanish into thin air. Most would likely be converted into branches of one of the nationwide banks. Consequently, while there would be fewer banks in each market there would not necessarily be fewer banking facilities.

But Canada might not provide a relevant comparison. First, Canadian banking policy differs from that of the United States in that it has been and remains a strictly federal function despite the provinces' high degree of autonomy in other areas (such as securities regulation). Unlike the United States, there was no conflict between the provinces and the federal government over banking structure. Second, while banking policy in the United States has at times encouraged the spread of small, local banks, Canadian policy seems to have favored larger banks. Specifically, while in the United States in 1900 a

Table II

Banks with Assets below \$500 Million Fifth Federal Reserve District

State	Number of Banks	Banks below \$500 Million
Maryland	108	96
North Carolina	78	68
South Carolina	84	78
Virginia	180	168
West Virginia	162	159
District of Columbia	26	20

Source: Consolidated Reports of Condition and Income, June 1990.

national bank could be chartered with as little as \$25,000 in capital, in Canada the Bank Act of 1871 required a minimum of \$500,000 in capital (Breckenridge 1910).

Finally, a structural outcome similar to the Canadian system is unlikely because small banks in the United States may have advantages over entrants into their markets simply by virtue of being there first. If a larger bank wishes to enter, it has to incur costs to buy its way in either de novo or by acquiring the incumbent. If the incumbent is earning above normal returns, the costs of entry might be worth incurring. But if the incumbent is simply earning a normal return, the entrant would have to have an advantage over the incumbent in order to make the costs of entry worth incurring. The advantage could occur on the supply side in the form of more efficient operations, or on the demand side in the form of enhanced services and credit availability that would make consumers willing to pay more. The point is that the eventual structure of American banking will depend to a large extent on the structure that is in place now and will not inevitably converge to that of Canada.

A more realistic comparison might be with California, which has explicitly allowed branching since 1909. California has 431 banks serving its 29.1 million population. The California banks per capita ratio applied to the entire United States implies about 3,700 banks. Still, such projections are precarious because they do not take into account advantages of incumbent banks in markets. At best, they represent an upper limit to what one might expect to happen. Given the divergence between the number of banks predicted by the ratios for Canada and California, the only prediction one can safely make is that the number of banks in the United States will fall but not by much.

Suppose, however, that the drastic reductions in the number of banks implied by the ratio for California or even for Canada were to come to pass. What would be the implications for consumer welfare? A rough idea of the answer may be inferred from a simulation of the potential for mergers in local banking markets in the United States (Burke 1984). The analysis simulated the maximum extent of concentration and minimum number of firms remaining in a market after the consummation of all possible mergers that did not violate the Department of Justice Merger Guidelines.⁶ No matter how many banks a market started with, the number of banks remaining in the market after all mergers were consummated averaged from four to six, assuming no entry from out-of-market competitors or de novo banks. In some markets, the number could fall as low as three before triggering an antitrust challenge.

The implication of the simulation results is that the number could fall substantially within most local markets before constituting undue concentration under the Department of Justice Merger Guidelines. Thus it could be that the 56 nationwide banks suggested by the analogy with Canada might be more than sufficient to preserve competition. Even if all 56 banks do not overlap in all markets, it is only necessary that some overlap in each market. So long as one accepts the Guidelines as a valid delineation of levels of concentration that might harm consumer welfare, one may infer that there is plenty of room for consolidation before the number of banks falls to levels with which regulators should be concerned.

Having considered the banks likely to be affected by interstate branching powers, the possible results of consolidation, and the implications for competition, one question remains: How likely are bank holding companies to consolidate their subsidiaries? One way to predict the likelihood of consolidation if interstate branching laws are liberalized is to look at the experience of bank holding companies in states that have liberalized their branching laws, since they would provide a situation analogous to the repeal of McFadden. At least one case study of Virginia showed that when state branching restrictions were liberalized, the majority of banks converted their subsidiary banks to branches (Kyrus 1982). More generally, Table III is a contingency table showing the frequency of consolidated and decentralized banks by size class in a sample of twelve states that have adopted statewide branching sometime during the last twenty years.⁷ As the analysis of an earlier section implied, the larger the bank holding company, the more likely it is to consolidate its subsidiaries into branches. Indeed, that is exactly what the frequencies in each column of Table III imply. The purpose of the analysis is to test whether the tendency to consolidate is statistically independent of size, since it is mostly larger organizations that operate on an interstate level and might therefore be likely to take advantage of interstate branching authority.

The strength of the association, measured as a χ^2 statistic, just fails the test of statistical significance at the 5 percent level of confidence. Thus while the numbers in the contingency table point to an increasing percentage of consolidation as organization size grows, the relationship is not strong in a statistical sense. As a result, the experience of bank holding companies within states that have liberalized their branching laws does not provide a strong basis for predicting that all interstate bank holding companies will automatically convert their subsidiaries to branches if the law so allows, at least in the short term. Despite the compelling arguments for consolidation of subsidiaries into branches, there are apparently sufficient benefits to decentralization to make the outcome vary widely across companies.

Table III

Consolidation vs. Decentralization Banks Larger than \$1 Billion in Assets

	\$1-5 Billion	\$5-10 Billion	Over \$10 Billion	Row Total
Branches	25 (46.30%)	13 (59.09%)	25 (71.43%)	63
Subsidiaries	29 (53.70%)	9 (40.91%)	10 (28.57%)	48
Column Total	54	22	35	111

Summary statistics: $\chi^2 = 5.526$ (Critical $\chi^2_{.05,2 \text{ d.f.}} = 5.99$) Note: Numbers in parentheses denote column frequencies.

⁶ According to the guidelines, mergers in unconcentrated markets (Herfindahl index below 1000) would not be challenged, those in moderately concentrated markets (Herfindahl index between 1000 and 1800) might be challenged if they raised the Herfindahl by at least 100 points, and those in highly concentrated markets (Herfindahl index above 1800) might be challenged if they raised the index by at least 50 points (*Federal Register*, June 29,1984).

⁷ The states are Florida, Louisiana, Massachusetts, Michigan, New Jersey, New York, Ohio, Oklahoma, Tennessee, Texas, Virginia, and West Virginia. Bank holding companies with combined bank assets of less than \$1 billion are excluded in order to limit the sample to companies with statewide operations instead of operations limited to one local area.

There are some qualifications to the results. First, most of the decentralized bank holding companies are operating in states that have liberalized their branching restrictions in the last five years, for example, Michigan, Ohio, and Texas. Second, at the time of this writing there appears to be a trend toward consolidation that may not yet have finished. For example, five of the bank holding companies in the sample announced or completed consolidations since June 1990. As a result, the numbers may reflect more consolidation over time, especially among the larger organizations. Finally, consolidation seems irreversible, since there are apparently no cases of consolidated banks that elected to spin off branches into subsidiaries. The implication of the qualifications is that at this time the contingency tables might not yet reflect long-run results.

CONCLUDING COMMENTS

The liberalization of geographical restraints on banking and other depository institutions has been a prominent feature of banking in the United States since the failures of the late 1920s and early 1930s. The liberalization has picked up momentum during the 1980s, during which barriers fell to both statewide branching and interstate bank holding company expansion. Given all that has happened, it would seem logical for the next step to be to relax restrictions on branching across state lines.

Despite the arguments in favor of interstate branching, it is not likely that permitting it would immediately revolutionize the banking structure of the United States. Assuming all interstate bank holding companies were to consolidate, the number of large banks, most of which do not compete directly with each other, would fall. But while interstate branching could lead to some interstate expansion that had not occurred before, it would not likely have much effect on the number of small banks, at least those that have survived the competition in states with liberal branching laws. And given that some bank holding companies have chosen to retain a decentralized structure within their states, it is possible that some interstate organizations could remain decentralized as well.

Still, a long-term benefit of permitting interstate branching is that it could pave the way for the development of a truly nationwide banking system with geographically diversified lending and funding sources. Since interstate branching would enable interstate organizations to operate at lower cost than under the current system, it could facilitate the development of expertise in interstate operations. While nationwide organizations might not develop immediately because of capital constraints and limited knowledge of markets outside of banks' local areas, the ability to expand in a sound manner will increase as bankers become accustomed to operating branch networks over wider areas. In the end, the result could be a mixture of large banks with nationwide branch networks and markets and smaller banks specializing in local markets.

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