

The Motivations Behind Banking Reform

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BEGINNING IN THE 1970S, MOST STATE legislatures adopted new laws that fundamentally reformed and deregulated the banking industry in the United States. The states dropped their prohibitions on bank branching within each state and further reforms permitted banking and branching across state lines, thereby ushering in the era of large regional and super-regional banks. Many economists have credited the reforms with modernizing the U.S. banking industry.

Banking was not the only sector of the American economy to see significant regulatory reform in the last quarter-century. Industries such as trucking, long-distance telecommunication, petroleum, natural gas, the railroads, airlines, and securities all underwent significant deregulation. Those efforts have prompted many scholars of regulatory activity to ask, what factors have driven the deregulation effort?

Scholars draw on several theories to explain regulatory change. One is the public interest theory, which holds that government intervenes in markets in an effort to correct market failure and maximize social welfare. In contrast, the private interest theory (also called the economic theory) characterizes the regulatory process as one in which well-organized groups use the coercive power of the state to capture rents at the expense of more dispersed groups. Other theories emphasize the importance of beliefs and ideology, and the institutional arrangements of the decision-making process.

The private interest theory often is effective in explaining regulatory interventions that are difficult to rationalize

on public interest grounds. But the theory is less successful in explaining deregulation; the public interest theory appears to better account for welfare-enhancing removal of regulation that increases competition. Does that mean that the pervasive economic deregulation of recent decades should be understood as motivated by concern for the public interest?

Unlike other recent deregulatory efforts that occurred at the national level, branching deregulation took place gradually on a state-by-state basis. (See Figure 1.) Though Congress passed several pieces of bank reform legislation, the state legislatures carried out most of the deregulation. Thus, branch reform in the states offers a rich laboratory in which to investigate what drives deregulation. Let us look at the timing and circumstances of different states' deregulatory activities in an effort to determine their motivation.

HISTORY OF BANKING REGULATION

To understand what factors may have prompted deregulation in the various states, we must first look at the history of banking regulation in the United States.

Regulation and state revenues Following the adoption of the U.S. Constitution, states were legally prohibited from issuing fiat money and taxing interstate commerce. Those prohibitions substantially lowered state revenues, forcing legislatures to look for other sources of income. One source that they quickly exploited was the chartering and regulation of banks. States received fees for granting charters, and they often owned or purchased shares in banks or levied taxes on banks. During the first few decades of the nineteenth century, for example, the bank-related share of total state revenues exceeded 10 percent in a dozen states.

To enhance those revenues, each legislature had an interest in restricting competition among banks. Because states received no charter fees from banks incorporated in other states, the legislatures moved quickly to prohibit out-

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of-state banks from operating in their territories – hence, the origin of the prohibition on interstate banking.

To further increase the number of chartered banks, legislatures also often restricted intra-state expansion. States would grant a charter for a specific location or limit bank branches to a city or county. By adopting branching restrictions, the states created a series of local monopolies from which they could extract part of the profits. Some state legislatures even passed “unit banking” laws that prevented banks from having any branches that would infringe on other banks’ local monopolies.

Such regulations, both then and now, produce beneficiaries who are loath to lose their protections and privileges. Benefits tend to be concentrated, while costs to consumers of a less efficient and competitive financial sector tend to be diffuse.

Intrastate deregulation Prior to the 1970s, most states restricted intrastate branching and all states forbade interstate branching. Although there had been some changes in state branching laws during the late nineteenth and early twentieth centuries, the laws remained stable for decades after the Great Depression. Some of the statutes were essentially unchanged for more than a century.

Since the early 1970s, however, 49 of the states have relaxed restrictions on intrastate branching. That deregulation typically involved three types of reforms. The first permitted the formation of multi-bank holding companies (MBHCs) that could own multiple banks but had to operate them separately. MBHC bank offices could not be integrated into a single network, so a depositor at one bank could not have access to her deposits at another. The banks in an MBHC also could not consolidate their back-office opera-

tions, and each bank had to meet all regulatory obligations (e.g., capital requirements) as if it were a stand-alone institution. The second stage of deregulation occurred when states began to allow branching by merger and acquisition. That permitted MBHCs to convert offices of subsidiary banks (originally held or acquired) into branches of a single bank. An MBHC could then integrate its banking offices into a single branch network. The third regulatory reform occurred when states permitted full statewide branching, whereby banks could open new branches anywhere within state borders.

Interstate deregulation The Douglas amendment to the federal Bank Holding Company Act of 1956 prevented holding companies from buying out-of-state banks unless the banks’ home state explicitly permitted such acquisitions by statute. Because no state allowed such acquisitions, holding companies effectively were prohibited from crossing state lines. But in 1975, the Maine legislature became the first to allow out-of-state bank holding companies to acquire in-state banks.

The federal government made further allowances for multi-state banks with the 1982 passage of the Garn-St. Germain Act that permitted out-of-state bank holding companies to acquire failing banks and thrifts. Following the passage of that legislation, many states began entering into regional or national reciprocal arrangements whereby their banks could be bought by MBHCs based in other states that were part of the arrangement. Between 1984 and 1988, 38 states signed such agreements. The state-by-state deregulation culminates in the passage of the 1994 Riegle-Neal Interstate Banking and Branching Efficiency Act that phased

out restrictions on banking and branching across state lines, thereby effectively codifying at the national level what had been occurring at the state level.

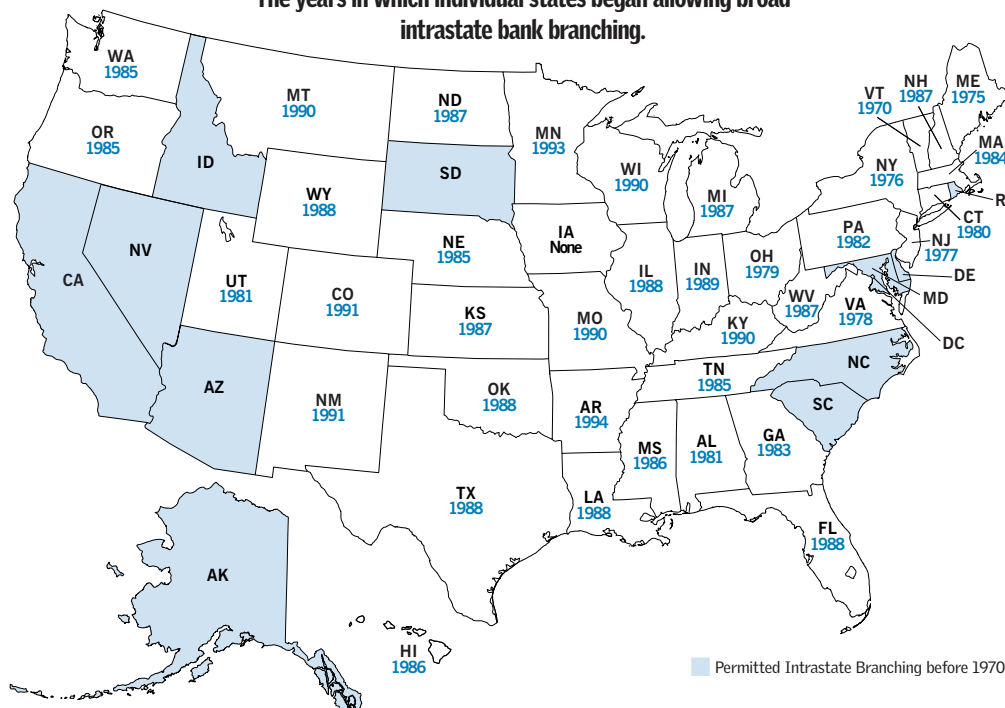
ALTERNATIVE EXPLANATIONS

To analyze possible motivations for state banking reform, Philip Strahan and I examined the timing of intrastate branching deregulation on mergers and acquisitions. We chose to look specifically at that reform because merger and acquisition deregulation is the only type of branching reform that consistently has a statistically significant effect on banking structure, bank efficiency, and overall economic growth. Moreover, the estimated mag-

Figure 1

Broadening the Branches

The years in which individual states began allowing broad intrastate bank branching.



nitudes of those effects are greatest for this type of intrastate branching deregulation.

Because Congress also became involved in banking reform, we considered the possible factors behind federal lawmakers' push to deregulate. To determine whether the same forces operated at both the state and national levels, we analyzed voting behavior in the U.S. House of Representatives on federal interstate branching legislation.

Intra-industry rivalry Throughout history and in the recent debates over reform, small banks have fought to maintain and extend branching restrictions. Smaller banks appear to be the main winners from anti-branching laws because the restrictions protect them from competition from larger, more efficient banking organizations. Among the anti-branching laws' apparent losers is the general public, because branching restrictions tend to reduce the efficiency and consumer convenience of the banking system, and small banks tend to be particularly inefficient in states where branching restrictions offer them the most protection.

The public interest theory implies that deregulation should occur first in the states where small banks have the largest market share because that larger market share translates into greater social costs, including deadweight costs and losses associated with inefficiencies and customer inconvenience. The private interest theory suggests precisely the opposite: branching deregulation should occur later in the states where small banks have more market share and, hence, more political influence.

Inter-industry rivalry A number of states permit state-chartered commercial banks to sell insurance. The insurance lobby in those states would thus oppose the relaxation of branching restrictions because such deregulation would enable banks to construct a more efficient insurance distribution network that would better be able to compete with the insurance industry itself.

According to the private interest theory, deregulation should occur later in states where banks can sell insurance and the insurance industry is more important relative to the banking industry. The efficiency costs of the branching restrictions, however, increase with the size of the insurance sector because the restrictions prevent the exploitation of scope economies of distributing banking and insurance products through the same network. Under the public interest theory, reform should occur earlier in states where banks

can sell insurance and the insurance industry is relatively large, because branching would provide more insurance options to the consumer.

Small Borrowers Banks are a major source of credit for small firms. Branching deregulation tends to reduce banks' local market power and improves conditions for borrowers. Although not without controversy, a number of studies have shown that lending to small business increases on average when banking organizations purchase small banks, and credit availability to small businesses increases in the years following banking organizations' takeover of small banks.

If bank borrowers do tend to benefit from branching deregulation in particular and bank consolidation in general, the private interest theory would predict that states with numerous small, bank-dependent firms would deregulate earlier. Interestingly, the public interest theory also suggests that those states would be among the first to deregulate because the social costs of the restrictions are higher in states with more small, bank-dependent firms.

Political-Institutional Factors The typical perception of Republicans is that they are more likely to favor deregulation than Democrats. The political-institutional theories thus suggest that states where Republicans dominate the political process will deregulate earlier than states where Democrats are the controlling party.

We also looked for a relationship between party control and the timing of deregulation. In particular, we studied whether reform becomes more likely when the same party controls both the legislature and the governorship. The political effects must be interpreted with caution because

Table 1

DELAY AND DEREGULATION: The impact of economic factors on the timing of deregulation, under public- and private interest theories.

Economic Factor	Empirical Proxy	Public Interest Theory Prediction	Private Interest Theory Prediction	Estimation Results
Intra-Industry Rivalry	Share of Small Banks in the State	Speed	Delay	Delayed by 4.7 years
Inter-Industry Rivalry	Share of Insurance Where Banks Compete	Speed	Delay	Delayed by 3.5 years
Users: Small Borrowers	Share of Small Firms in the State	Speed	Speed	Speed by 3 years

Note: The results are the impact of a one-standard-deviation increase in the variable on the timing of deregulation estimated in a hazard model for the period 1970 to 1992.

Variable Definitions:

■ The proxy for the relative strength of the small banks is the fraction of banking assets in the state in "small" banks, where small banks are those with assets below the median size in each state in each year.

■ The proxy for the relative strength of insurance interests is the size of the insurance sector (defined as total value added in the

state) relative to the sum of the value-added in banking plus insurance sectors in each year. The impact of this variable is then considered separately for states that do and do not permit banks to compete with insurance.

■ The proxy for the relative strength of small, bank-dependent borrowers is the fraction of all establishments operating in the state with fewer than 20 employees.

the views of the politicians may simply reflect the economic interests of the constituents in the state.

ANALYSIS RESULTS

To carry out our analysis, we assessed the relative importance of factors representing each alternative explanation in speeding or delaying deregulation. Specifically, we looked for how the factors that we have described influenced the timing of state-level branching deregulation during the last 30 years. A hazard model technique allowed us to estimate how differences across states, as well as changes in those factors over time, tended to speed or to delay deregulation.

Motivations in the state legislature

The private interest approach receives both economically and statistically significant support in the data, as we see in Table 1. As the share of small banks in the state increases, we see that deregulation is delayed. In particular, a one-standard-deviation increase in the small bank share resulted in an increase in the time until deregulation of 30 percent, equal to about 4.7 years. (The average time between 1970 and branching deregulation is 16 years.) That result is consistent with the intra-industry rivalry implications of the private interest theory but contrary to the implications of the public interest theory.

The factors considered under inter-industry competition also help to explain the timing of deregulation. In states where banks could sell insurance, a relatively large insurance sector is associated with an increase in the expected time to deregulation. A one-standard-deviation increase in the relative size of the insurance sector in the states that permitted banks to sell insurance led to a 22-percent increase in the time until deregulation, or about 3.5 years. That result again is consistent with the private interest theory but not the public interest theory.

Deregulation occurred earlier in states where small, bank-dependent firms are relatively numerous. A one-standard-deviation increase in the share of small firms reduced the time until deregulation by 18 percent, or about three years. That result is consistent with both the private and public interest theories.

Finally, the partisan structure of the state governments also appears to influence when states deregulated. As expected, a higher proportion of Democrats in the government tends to correspond with a delay in deregulation. A one-standard-deviation rise in the share of the government controlled by Democrats translates to a two-year delay in deregulation as compared to a Republican-controlled state government. Whether one party controls both the legislator and the governorship in a state, however, did not appear to affect the timing of deregulation.

Our analysis strongly suggests that private interests do play an important role in the deregulatory process.

Although private interests and public interests do sometimes coincide, the results on the relative market share of small banks and on the relative size of insurance in states where banks compete are consistent with a private interest approach but are difficult to explain on public interest grounds.

To check the plausibility of the results, we should consider whether the ex post consequences of deregulation are consistent with the ex ante lobbying positions attributed to each interest group. Small banks lose market share following deregulation and, in states where banks can enter the insurance business, the insurance sector shrinks rel-

Groups that will benefit from deregulation will lobby to speed reform, while groups that will be harmed by deregulation will lobby to delay it.

ative to the banking sector following deregulation. Borrowers also benefit because the average interest rates on loans tend to fall following branching deregulation. Those considerations support the private interest interpretation of the results described above: Groups that will benefit from deregulation will lobby to speed reform, while groups that will be harmed by deregulation will lobby to delay reform.

The U.S. House of Representatives Do the forces driving intrastate branching deregulation also drive interstate deregulation at the federal level? Financial services interests are active contributors and lobbyists in Washington. Researchers have found that financial services political action committees constitute the largest group of contributors to federal legislators, providing nearly 20 percent of total congressional campaign contribution. Much of their lobbying effort involves competition among rival interests within financial services.

After virtually all states adopted intra- and interstate branching deregulation, the 1994 Riegle-Neal Act repealed the 1927 McFadden Act, thus phasing out all barriers to interstate banking and branching by 1997. It is difficult to analyze data from that legislation for our study: the key votes concerning the Riegle-Neal Act were either voice votes or extremely lopsided, so it is not possible to estimate a voting model for them. Several bills and amendments related to interstate branching were debated in Congress during the years prior to Riegle-Neal, but a search of the weekly *BNA Banking Reporter* and the *Congressional Record* produced only one non-lopsided roll-call vote related to interstate branching. That vote occurred in the House of Representatives on November

14, 1991, on an amendment sponsored by Rep. Chalmers Wylie (R-Ohio) and Rep. Stephen Neal (D-N.C.) to introduce interstate banking and branching deregulation into a financial services reform package. Although the amendment passed by 210 to 208, the bill to which it was attached subsequently was defeated.

To check for the impact of the factors that were found to be influential in the state-level reforms, we should consider both the sponsorship of interstate banking legislation and the voting on the amendment. The sponsors of the Wylie-Neal amendment were from states with low small-bank market shares: 0.04 for Wylie's Ohio and 0.02 for Neal's North Carolina. In contrast, the sample mean in 1991 was 0.08 (median = 0.07). Michigan, home state of Riegle-Neal's Senate sponsor, Sen. Donald Riegle Jr., also had a relatively low small-bank market share of 0.05.

Consistent with the state-level deregulation process, a "probit" analysis of voting patterns showed that legislators were more likely to support the amendment if their states have a relatively low market share of small banks. As in the analysis of the timing of intrastate deregulation, the fraction of small banks was the most important interest group influence on a legislator's voting decision. The impact of rival interests outside of banking was also consistent with intrastate deregulation results. Where banks could sell insurance, legislators from states with larger insurance sectors relative to banking were less likely to vote in favor of interstate branching. Overall, the analysis of the vote on federal branching deregulation supported the private interest theory of deregulation and provided a con-

sistency check that the importance of interests operating on the state legislatures was very similar to those operating at the federal level.

WHY DID BRANCHING DEREGULATION BEGIN IN THE 1970S?

In order for us to complete our study of motivating factors behind bank deregulation, we should offer an explanation for why deregulation began in the 1970s. Put simply, we

The analysis of federal branching deregulation indicated that special interests on the state level were also operating on the federal level.

believe that broad technological, legal, and economic shocks altered the political-economy equilibrium that had kept anti-branching regulations little changed for at least 30 years.

Beginning in the 1970s, three innovations reduced the value of local geographic monopolies to the protected banks. (See Table 2.) First, automatic teller machines (ATMs) helped to erode the geographic ties between customers and banks. Small banks challenged the legality of ATM networks as unlawful interstate branches, but the courts declared that an ATM did not constitute a branch. Second, checkable money market mutual funds and the Merrill Lynch Cash Management Account demonstrated that bank-

ing by mail and telephone provided a convenient alternative to local banks. Third, technological innovation and deregulation reduced transportation and communication costs, particularly since the 1970s, thereby lowering the costs for customers to use distant banks. By increasing the elasticity of deposits supplied to banks, those innovations reduced the value of geographical restrictions to their traditional beneficiaries and thereby reduced

Table 2

MODERN BANKING: Trends in commercial banking, 1950 to 1995.

Year	Number of ATMs	Domestic bank deposits (billions of \$)	Money market mutual funds (billions of \$)	Percent of deposits and mutual funds held by banks	Small banks' percentage of assets	Average annual number of bank failures**
1950	0	154	0	100	N/A	4
1955	0	191	0	100	N/A	3
1960	0	228	0	100	24	2
1965	0	330	0	100	20	4
1970	0	479	0	100	18	6
1975	9,750*	775	4	99	18	6
1980	18,500	1,182	76	94	17	10
1985	61,117	1,787	242	88	14	60
1990	80,156	2,339	493	83	11	179
1995	122,706	2,552	745	77	8	61

* The ATM figure is from 1978, the first year for which complete data are available.

** Average annual number of depository institution failures during the previous five-year interval.

their incentive to fight to maintain them.

On the lending side, increasing sophistication of credit-scoring techniques, following innovations in information processing, financial theory, and the development of large credit databases, began to diminish the value of knowledge that local bankers had about the risks of borrowers in the community. As a result of those innovations, a national market developed for residential mortgages, credit card receivables were securitized, and bank lending to small business began to rely less heavily on the judgment of loan officers and more on standardized scoring models.

The changes increased the potential profitability for large banks to enter what had been the core of small bank activities. Large banks' incentive to increase their lobbying pressure to be able to expand into those markets had thus increased over time. In fact, small banks' market share began to decline even prior to the branching deregulation. As the value of local banking relationships declined, small firms that were the main borrowers from the small banks also became more likely to favor the entry of large banks into local markets. With the deadweight costs of preventing large bank entry rising, the private interest theory predicts that small local banks would become less able to maintain the branching restrictions. Deregulation that reduces deadweight costs of regulation, however, also is consistent with the public interest theory.

As Edward J. Kane argued in his 1996 article "De Jure Interstate Banking: Why Not Now?" another major shock to the old equilibrium was the increasing public awareness of the costliness of financial institutions that were government-insured but geographically undiversified. In the late 1970s, the failure rate of banks began to rise. In the 1980s, the savings and loan crisis and subsequent taxpayer bailout further heightened public awareness about the costs of restrictions. The failures may have increased public support for branching deregulation across the board.

Those technological, economic, and legal shocks generated conditions that changed the longstanding balance favoring the anti-branching forces. The marginal value of lobbying to repeal branching restrictions increased just as the relative value to the small banks of maintaining branching restrictions was declining. Although it is possible that a broad change in "ideology" against government regulation could explain the support for deregulation, it is difficult to explain what drove the ideological change independent of the factors discussed above.

CONCLUSIONS

The private interest theory of regulation can account for the pattern of bank branching deregulation during the last 30 years. Beneficiaries of branching regulation had supported a coalition favoring geographical restrictions despite their costs to consumers. Various innovations that began in the 1970s altered the value of the restrictions to the affected parties, and the resulting competition among interest groups can explain the subsequent deregulation. While some of the results also are consistent with the public interest theory,

other results – particularly evidence on the importance of rivalries between small and large banks and between banking and insurance – are difficult to explain with the public interest approach. Political-institutional factors appear to affect deregulation, although those variables may act as proxies for unmeasured economic interests. Future empirical studies of endogenous deregulation may be particularly fruitful where change has occurred across states over time, such as in franchising, insurance, and public utilities.

Technological and financial innovations will continue to erode the benefits to any interest group of maintaining regulatory barriers in financial services. Those forces are likely to bring about reforms both domestically, for example, the Gramm-Leach-Bliley Financial Modernization Act of 1999 that removed restrictions on bank powers, and internationally, for example, through the extension of financial services provisions of the North American Free Trade Agreement to reduce geographic barriers across countries. **R**

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