Changing Retail Banking Supply-Demand Mismatch: A Tale of Two States

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ABSTRACT

In this study, the author compares the supply-demand mismatch of retail banking services and the changing patterns in Illinois and New York from 1982 to 2007 amid fundamental banking transformation and geographical deregulation. The study uses measures of concentration like the Herfindahl-Hirschman Index (HHI) and the E-Index. The study finds that the traditionally unit banking Illinois has narrowed the mismatch over the study period from 1982 to 2007, whereas the traditionally branch banking New York has expanded such mismatch. The study also finds that while the New York banking industry can be characterized by a more concentrated geographical distribution of bank deposits, the Illinois banking industry still has a dispersed geographical concentration of bank offices, though the Chicago MSA has reversed such a pattern.

Keywords: Banking, Branching, Concentration, Deregulation, E-Index, HHI, Illinois, Markets, Mismatch, New York

INTRODUCTION

For nearly three decades, the U.S. banking industry has undergone fundamental consolidation. From 1980 to 2008, while the total assets in the nation’s commercial banks more than doubled from $22 billion to $58 billion (in 1982-84 price), the total number of commercial banks reduced in half, from 14,434 to 7,203. The percent of domestic deposits controlled by the 50 largest banks rose from 31% to 60%. One important area of banking transformation is geographical deregulation and the resultant branch banking expansion (Berger et al., 1999; DeYoung et al., 2004). From 1980 to 2008, while the number of commercial banks in the United States reduced by 50%, the number of branch offices increased by 102%. During the same period, the U.S. population increased by 33%, and the total personal income, a measure of flow of wealth, increased by 90%. The fact that branch offices increased more than the total population and wealth means that branch office expansion was in part to meet the under-served needs due to traditional branch restrictions. Indeed, the nation’s banking industry has increasingly been built on branch banking. From 1980 to 2007, the number of unit banks (a unit bank has only

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one office, *i.e.*, the head office.) dropped from 7,502 to 1,901, a 75% reduction. The percentage of commercial banks with branch offices increased from 47% to 74%. Such changes in branch banking will have significant impact on the retail banking market conditions.

This paper investigates one particular aspect of changes in retail banking, the changing retail banking supply-demand mismatch, using Illinois and New York in a comparison case study. The motivation for the study is straightforward: if traditional branch restrictions limited branch banking, the bank office supply must fall below bank market demand. Such supply-demand mismatch should decline with geographical deregulation and branch banking expansion, especially in the traditional unit banking states, such as Illinois. However, instead of examining Illinois in isolation, the study also investigates the changing supply-demand mismatch condition in New York. There are two main reasons for a comparison study such as this. First, unlike Illinois, prior to nationwide banking deregulation in the late 1990s, New York had been a branch banking state allowing statewide branching for two decades. Thus a comparison study would help discover trends that may vary between states with different regulatory traditions and frameworks. Secondly, similar to Illinois banking which is dominated by the Chicago Metropolitan Area, New York banking is dominated by the New York Metropolitan Area. A comparison study between Illinois and New York would help control for the effect of such a unique structure in banking. In addition, the extraordinary development of the banking industry, along with the fundamental consolidation and geographical expansions of the last few decades, may have come to a major halt with the spectacular collapse of the United States financial system around 2007-2008. Since the study uses data up to 2007, it may document the spatial pattern on the eve of the collapse. Thus, the study may serve as a watershed case for future comparison studies using the post-2007 data.

**Retail Banking Market and Supply-Demand Mismatch**

The traditional general equilibrium model of resource allocation assumes a seamless direct market and gives no role to financial intermediaries (banks included), and by extension to their locations (Allen & Santomero, 1998). However, financial intermediation theory suggests that transactions (gathering customer credit information, monitoring loan performance and obtaining knowledge of activities financed by bank lending) carry real costs and risks and thus help break down bank markets into disjoined segments (Gurley & Shaw, 1960). These transaction costs in many ways are associated with distance and location (Brevoort & Wolken, 2008), and thus contribute to geographic fragmentation of local retail banking. Consequently, retail market information is location-specific and retail banking services are local in nature (Hannan & Prager, 2001). Indeed, as Cooperman et al. (1991) observe, the U.S. banking system operates as a collection of segmented markets involving retail customers, and some integrated banking systems involving regional and national (even international) corporate clients.

Branch banking emerged as a mechanism in bridging retail market fragmentation and the need for institutional integrity. The widely cited benefit of branch banking is centered on the diversification associated with an institutional structure spreading across a geographically differentiated space (Gart, 1994). Three specific forms of diversification are identified. The first is lending diversification associated with various businesses and industries located in different geographical markets. If different industries are affected by different shocks (A shock refers to any major sudden change in supply or demand conditions such as a sharp jump in cost or declining demand), such diversification would reduce exposure to an industry-specific downturn (Carlson, 2001). Secondly, branching may diversify a bank’s portfolio with respect to spatial shocks (Southworth, 1929; Wheelock, 1992). A location specific natural disaster would
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