Deregulation: The Attack on Geographic Barriers

with John M. Godfrey

Geographic restrictions seriously affect banks' ability to compete with S&Ls and nondepository institutions. In response to questions, Research Officer John M. Godfrey explains how the restrictions evolved and how banks were able to partially circumvent the barriers. He also outlines the timing and direction of the changes most likely to be made in the geographic restraints.

Q "Deregulation" has become a focus of controversy in banking recently. Some observers think the recent legislation has not gone far enough, while others believe it may have gone too far. What is the basic thrust of "deregulation" in the banking industry?

A The primary aim of deregulation in any industry is to establish a "level playing field" for all competitors. The recent deregulation of the transportation industry, for example, created more competition on the basis of price and service and reduced geographic restraints. Legislative deregulation came to transportation, however, only after many barriers had already crumbled or had been circumvented by aggressive firms.

Now, with the phasing out of restrictions on consumer services and other products, deregulation is occurring for depository institutions. Recognizing that many of the distinctions between depository institutions have been reduced in recent years, Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980. This Act is a first step toward establishing a "level playing field" for regulated depository institutions. But the Act still does not address a growing problem in the financial industry: There are still many nonregulated firms, such as finance companies, money market mutual funds, and financial service companies. In other words, the Act puts domestic commercial banks on a more "level playing field," but it still does not free them to play on the entire field. A variety of restrictions contribute to this problem, the most significant of which are the geographic restraints.

This topic is especially germane now because the International Banking Act of 1978 required President Carter, after consulting with the Attorney General, the Secretary of the Treasury and the three bank regulatory agencies, to report to Congress his recommendations on the relevance of geographic restrictions on banking. The White House report was initially due in September 1979 and was transmitted to Congress in January 1981. Whatever the President's recommendations and the subsequent actions by Congress, they will have important implications for banks and bankers. Banks have the technology and the incentive to compete. But a major restraint is legislatively imposed geographic barriers set by the federal and state governments.

Q What is the relationship between federal and state geographic restraints on banking, and how did these restraints develop in the first place?

A Historically, federal regulators have deferred to state branching regulations. The present federal restrictions have been in place for more than 50 years, with only slight modification. Initially, national banks were prohibited from operating more than one full-service office. Many state-chartered banks were free to branch according to state regulations. With a more dispersed society in the 1920's, national banks operated at an increasing disadvantage relative to the full-service branch operations of state banks in some areas. Increasingly, national banks began to convert to state charters. The McFadden Act of 1927 partially rectified this competitive imbalance by permitting national banks to operate branches within their respective city limits if state law allowed state banks this freedom. And the Banking Act of 1933 allowed national banks to branch to the same extent permitted to state banks by state law. Since 1927, however, McFadden has led to more restrictions on banks because it defines a branch as "any place of business...at which deposits are received, or checks paid, or money lent." Accordingly, the courts have limited sites for bank automatic teller machines (ATMs) to branch locations. And while national banks may operate interstate loan production offices (LPOs), they cannot actually "make" a loan or dispense the funds from that LPO. As a result of McFadden, all national banks are restrained by the various branching laws of the 50 states.

State branching regulations, then, are the controlling factor in bank branching. These state regulations range from statewide branching—in 22 states—to unit banking—in 11 states. The remaining states allow only some form of limited branching. In addition, the multibank holding company is prohibited in 10 states, generally the same states that prohibit branching. There has been some liberalization at the state level over the last twenty years. For example, Florida, a unit banking state, moved to county-wide branching in 1977 and statewide branching in 1980. Geographic expansion, however, remains limited. As a result, of the 14,700 banks in this country nearly 5,800 are located in the 11 unit banking states.

Interstate banking was effectively curtailed in 1956 by the Douglas Amendment to the Bank Holding Company Act. The Act prohibited the acquisition of a bank in any but a bank holding company's home state unless expressly authorized by state law. Twelve interstate banking operations were "grandfathered." Several, like California-based Western Bancorporation, with 22 banks in 11 western states and over $21 billion in deposits, have significant interstate operations. Currently, Iowa allows new acquisitions by one out of state bank holding company, and Maine allows bank holding company acquisitions from states that allow acquisitions by Maine bank holding companies.

Q **Earlier, you mentioned that banks are not "playing on the whole field." How serious is this problem for banks?**

A These restrictions are quite severe when you consider that present geographic restrictions on the bank's major competitors are generally much lighter or nonexistent. Federal savings and loan associations can branch statewide, even in states that limit banks to a single office or limited facilities. This disadvantage may not have seemed so crucial to banks previously, but it will when S&Ls begin to offer NOW accounts. Banks located in unit or limited branching states will operate at a considerable competitive disadvantage vis-a-vis S&Ls. And banks are even more handicapped in competing with those nondepository institutions that are not regulated as to geographic expansion, such as finance companies, money market mutual funds, and brokerage firms.

Q **Despite these handicaps, some banks seem to be operating across geographic boundaries. How are they managing to get around the restraints?**

A Since the McFadden definition of a branch has effectively prohibited banks from establishing out-of-state deposit-gathering facilities, interstate bank expansion has focused mainly on lending. Major bank holding companies have established or acquired mortgage lending and commercial and consumer finance companies that operate in many states. Banks, for example, have established loan production offices to serve their corporate loan customers. Generally, however, these actions have resulted in more expensive and less efficient ways of serving customers than full-service operations.

More recently, the International Banking Act of 1978 expanded the banks' ability to establish branches of Edge Act corporations through which they can serve the international credit and deposit needs of domestic and foreign customers at many U.S. locations.

As a result, despite the aforementioned restrictions, the banking industry has found a variety of methods to expand toward nationwide proportions. Two major bank holding companies, for example, have achieved extensive national coverage. Each has about 400 offices that are located in roughly 40 states. So, interstate banking has already arrived for some domestic banking organizations, and they will have a head start when interstate restrictions are removed.

Foreign banks, too, have extensive operations, although the recent International Banking Act limits their ability to operate and expand interstate under more favorable conditions than domestically chartered banks. The ability of foreign banks to operate across state boundaries in ways prohibited to domestic banks has highlighted the need to revise the interstate banking regulations, especially in emergency situations.

Q **Not all bankers seem to favor deregulation. What are the major issues in the discussion?**

A Many bankers fear that if the restrictions were lifted, they would lose their protected markets. The results, they feel, would be damaging not only to local bankers but to the communities they serve. Other observers, however, argue that lifting the barriers would result in greater competition and, therefore, greater public benefits. Research into these issues, unfortunately, has not yet produced conclusive results. The debate and the research go on, but the trend toward lowering geographic barriers—in banking as in other industries—seems to be inevitable.

I can't examine in detail here all the issues raised by geographic deregulation, but let me review several of the most often cited issues. For example, when banking organizations enter a new market, there are likely to be short-term price benefits for the public. And, generally speaking, a relaxation of restrictions results in an increase in the number of banking offices and a wider variety of banking services.

On the other side of the fence, some argue against relaxing these restrictions on the grounds that it would lead to a concentration of banking resources. Of course, it is true that "measured" concentrations would increase at the state levels. But there are adequate public policy safeguards to prevent undue or excess concentration, and increased statewide concentration does not preclude meaningful competition in local markets.

Underlying all of this debate is the fact that, because of our longstanding restrictions, we have far more banks than other countries have. Unless the present restrictions are phased out in an orderly manner, there could be a sharp contraction in the number of independently operated banks. This would not be entirely desirable. We would probably want to avoid the situation where, as in Canada, West Germany, and the United Kingdom, commercial banking is dominated by a handful of large banks.

Q **What are the chances of that happening in the U.S.?**

A If the experience in such longstanding statewide branching states as California and North Carolina is a guide, community banks can successfully compete. More recently, when New York and Virginia relaxed their branching laws, smaller banks still remained. A reasonable balance might be possible where our banking structure could evolve into a number of large nationwide organizations and a large number of strong regional and local banks.

Even the often cited fear that branching will eliminate the independent bank and deprive the local community of adequate funds seems unfounded by past experience. Bank costs decline only slightly as size increases. Therefore, large banks do not necessarily have significantly lower costs than most banks, although the very smallest banks quite likely do have higher costs. And the various "High Performance Banking" studies show that banks in the $25-100 million size range earn significantly higher profit margins than the larger urban banks. Therefore, unless large banks adopt predatory prices, well-run and reasonably able independent bank managers should be able to remain competitive with adequate earnings. In the event a community bank is acquired by a holding company, past acquisitions show that these banks continue to service local borrowers and generally lend out a higher proportion of their funds.

Despite the evidence that points to increased public benefits of liberalizing geographic barriers, the task will not be easy. We must recognize that a large number of independent banks and bankers have long operated under a protective umbrella of geographic restraints. They have strong views on this subject and many legitimate concerns. These concerns must be reconciled in any political discussion.

Q **Keeping in mind that there are political issues as well as regional and local controversies involved, what might we realistically expect to see in the way of relaxation of these geographic restraints?**

A I see us moving toward three basic changes, which, taken together, seem to promise a reasonable compromise between completely eliminating all geographic barriers and maintaining the status quo.

First, I believe we will see bank holding company acquisitions across state lines. This most likely will come in three directions because of the potential for excessive concentration if all restraints were immediately relaxed.

1. Allowing interstate acquisitions in contiguous states or within a region.
2. Allowing the largest bank holding companies to enter only the larger metropolitan markets and only by *de novo* entry or acquisitions of the smaller banks in such markets.
3. Allowing domestic and foreign banking organizations to bid for financially troubled or failing banks.

Second, I look for some changes aimed at improving retail banking services within metropolitan areas by relaxing these geographic restraints in two steps.

a. Instead of classifying ATM/EFTS as branches, Congress could allow these services within "natural" market areas at first—including crossing local and state political boundaries, then within a region—and, finally, nationwide.
b. Banks might later be allowed to establish full-service branches throughout their "natural" market areas. This would be the most controversial change, since it would directly raise the issue of states' control of bank branching.

Finally, I think Congress may permit nationwide wholesale banking by allowing loan production offices to "make" business loans on site.

The removal of these barriers will not be easy, nor will they all come quickly. They all involve the removal of a protective barrier for some banks and bankers, and this is an important consideration. But the trend toward relaxation of geographic restraints seems inevitable, and the changes I have outlined suggest the direction in which public policy seems to be moving. ER