Nonlocal Competition for Banking Services

Arnold A. Heggestad, Chairman, Department of Finance, Insurance, and Real Estate, University of Florida (and Visiting Scholar at the Federal Reserve Bank of Atlanta), **notes that nonlocal competition is only growing in selected markets. But whether this expansion is a response to real economies or simply a result of regulatory treatment is a question for further research.**

How will competition from outside the local area affect banking markets? We have little evidence at present, even though nonlocal competition is undeniably here. Several basic issues need study.

I define nonlocal competition as banking-related activity in a market by banks headquartered in other cities. The primary concern, however, is the study of banks operating across state and national borders. This public policy area requires intensive study of its current importance, its current effects on market performance, and its potential for future growth.[1]

The ultimate impact on nonlocal competition is on market performance. As nonlocal competition increases, all firms may compete more intensely with resulting lower loan rates, better service, and higher rates for deposit funds. In addition, the efficiency of financial intermediation may be improved by increasing the linkage between markets, thus allowing for a more responsive allocation of credit.

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The McFadden Act and the Douglas Amendments to the Bank Company Act prohibit banks from crossing state lines to conduct a full commercial banking business. However, banking organizations can conduct numerous activities that are not legally restricted. These range from calling on potential loan customers to the establishment of specialized facilities in the target markets. The most common form of entry has been to establish subsidiaries of bank holding companies which are aimed at specialized financial markets. Generally, they are identified with the parent financial institution.

1. The current degree of nonlocal competition has recently been studied by Peter Merrill Associates, **The Environment for Nonlocal Competition in U.S. Banking Markets**, American Bankers Association, 1981.

TABLE 1. MAJOR NON-LOCAL ACTIVITIES BY FUNCTION AND BY CLIENT TYPE

MAJOR FUNCTION \ MARKET TYPE	CONSUMER (RETAIL) MARKET	CORPORATE MARKET	BOTH CONSUMER AND CORPORATE	FINANCIAL INSTITUTIONS
Lending		Corporate Calling Officers		Corporate Calling
		Loan Production Offices		
		Edge Act Corporations → 1		
		Factors		
		Mortgage & Real Estate Companies	Mortgage & Real Estate Companies	
		Industrial Finance Companies		Mortgage Banking Companies
		Mortgage Banking Companies		Correspondent Services
	Credit Cards			
	Industrial Banks			
	Consumer Finance Companies → 2			
Deposit-Taking → 4				
	Industrial Banks			Correspondent Services
	3	Edge Act Corporations → 1		
Fee Income Producing	Travelers Checks	Leasing Companies		Correspondent Services
	Investment Advisory Firms		Trust Companies	

Source: Peter Merrill Associates, **The Environment for Nonlocal Competition in U.S. Banking Markets**, American Bankers Association, 1981.

1. Edge Act Corporations, while aimed primarily at corporations engaged in import and export, have the potential for dealing with individuals engaged in these activities or domiciled outside the U.S.
2. Consumer Finance Companies in some states can issue "thrift certificates" or similar debt instruments; insurance must be provided locally, by private or quasi-public (but non-FDIC) means.
3. Travelers checks, by generating float, have a deposit-like characteristic.
4. If and when banks are allowed to pay interest on credit balances, credit cards become a "deposit" instrument.

Nonlocal competition appears to be a growing phenomenon in *only a subset of financial markets.* Generally, these markets all share three characteristics — large size, the existence of specialized submarkets, and growth potential. Characteristically, entry is most common in markets where there is a regulatory advantage to operating within the market.

Why is Non-Local Competition Expanding?

It is clear that all dimensions of banking competition have increased in recent years. Nonlocal competition is no exception. Several major developments have led to increases in the amount of nonlocal competition in the past decade. First, the economy has experienced shifts in relative growth rates. Banks that are headquartered in the industrial Northeast have not grown relative to banks operating in the Sunbelt and the energy states. Thus, there has been an incentive for banks to obtain a presence in rapidly growing markets. Second, states have treated their financial institutions quite differently. In some states, tax, branching, and usury laws are more favorable. Third, technology now permits operations in a wide geographic area. Communications systems and travel have made it feasible to maintain a geographically-dispersed operation.

The McFadden Act will in all likelihood be removed or amended within the next several years. This has had a differing impact on the desire to diversify into new markets. For regional banks, uncertainty on McFadden has delayed their geographic expansion. Their preferred form of expansion will be through acquisition of existing banks in other states. At the same time, many money center banks fear they will be forbidden to enter desirable markets by aquisition. Thus, they have used other devices to enter these markets, even some that may not be profitable in the short run. This approach at least gives a presence in many markets.

Potential Impact

Nonlocal competition has accelerated in intensity and importance. However, relative to other changes in competition, nonlocal would only rank third. The thrift institutions have obtained new powers to compete directly with banks. Additionally, nondeposit companies ranging from insurance and credit card companies to money market funds have had tremendous growth in many markets. In both cases, their impacts have exceeded the impact of the presence of out-of-state banks.

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The most important element of change in nonlocal competition is the impact it will have on market performance. As out-of-state banks enter, there will be an increase in the number of firms competing within the market. Additionally, there will be a substantial increase in competition for specialized functions. For example, there may be within any market only a few firms involved in international lending. This number would be increased substantially by Edge Act companies (internationally-oriented banking subsidiaries usually located outside a bank's own state). The result should be better performance with respect to interest rates, other fees, and services.

This element of performance raises a very serious question, however. Are the increases in competition due to greater efficiency, i.e., real

TABLE 2. NUMBER OF APPLICATIONS APPROVED FOR OUT-OF-STATE BANK - RELATED ACTIVITIES FOR BANK HOLDING COMPANIES.

June 1, 1971-December 31, 1977[1]

Activity	Acquisition of Existing Businesses	De Novo	Total
Finance Company (Commercial, Consumer, Insurance Premium, Mobile Home, and Agricultural)	73	436	509
Insurance	44	202	246
Mortgage Banking	30	172	202
Real and Personal Property Leasing	14	102	116
Investment Services	5	28	33
Factoring	5	24	29
Industrial Banking	3	18	21
Data Processing	2	19	21
Trust Operations	6	11	17
Community Welfare Investments	0	2	2
Miscellaneous	8	7	15
TOTAL	190	1,021	1,211

[1]The figures in this table are intended to indicate the approximate magnitude and relative importance of out-of-state expansion by bank holding companies in various bank-related fields. However, the figures are likely to be understated in several respects. An application to acquire an existing company, or notification of intention to expand *de novo*, may involve expansion of services at several locations, only one of which would be listed in the Federal Reserve announcement and hence would be included in these figures. Also, in some cases, an application to engage in two or more activities may have been recorded only once, as if it were an application for one activity.

Source: Golembe Associates, "A Study of Interstate Banking by Bank Holding Holding Companies, Prepared for Association of Bank Holding Companies, May 1979.

economies, or are they simply due to "pecuniary" economies; specifically, more favored regulatory treatment. For example, money center banks maintain capital to asset ratios substantially lower than most regional banks. As a result, they can maintain a lower operating margin with lower loan rates or higher deposit rates than regional competitors. This gives them an advantage. It improves the performance within that market but at some cost in competitive equity.

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There are additional elements of performance relating to changes in the structure. This has been studied within states but, since this phenomenon is quite new, never across states. First, the increases in nonlocal competition will have some implications for overall concentration of resources. As state boundaries are broken down by de facto banking, the larger banks are likely to increase their share relative to smaller banks. The second factor is the increase in the number of links between markets. Banks will now be meeting in many more markets; this may affect how much they are willing to compete in any single market.

An additional performance implication of this trend is the effect on intermediation. Will the presence of subsidiaries operating in markets facilitate the coordination of borrowers and lenders? Will the private market, operating through its own decision process, be more efficient than existing financial markets?

Finally, nonlocal competition by necessity is carried out through indirect means. Within a rapidly growing market there may be loan production offices that offer commercial loans, Edge Act companies that deal in international transactions, and consumer finance companies that only make consumer loans. Would the system be more efficient if all these services were collapsed into basically diversified commercial banking firms? This area is critical for future policy. ER

—Arnold A. Heggestad