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FINANCIAL INSTITUTIONS GO INTERSTATE

Remarks by

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before the

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I appreciate this opportunity to meet with you and discuss the continuing evolution of our financial system. In the last few years, so much has changed in the economy and in the structure and regulation of financial institutions that we have had to adjust to a totally new environment. The adjustment period, while leading to long term benefits, has been very difficult for many institutions, especially in your industry.

As required by law, we are finally nearing the end of the interest rate deregulation schedule. The few remaining controls will expire at the end of this month, and institutions will be free to establish their own terms on all deposits and borrowings except demand deposits. In just a few short years, interest rate deregulation has vastly expanded the options available to savers and has provided financial institutions with many new ways to compete for deposits. We have come a long way from the era of the low interest rate passbook savings account.

Coincident with this period of rapid interest rate deregulation, we have begun the process of geographic deregulation. Thus far, relatively few banks and thrifts have been involved in the interstate banking movement. But, before long, an interstate merger or the opening of an out-of-state branch won't be major news. This movement toward interstate financial services will be the focus of my remarks today.

For a variety of historical reasons, this country has chosen to restrict the geographic expansion of depository institutions. Unlike other countries that have a few nationwide financial organizations, the United States has developed a system of small locally-oriented banks and thrifts. The original savings and loan associations, established solely to finance their members' home purchases, were typical of the local nature of American financial institutions.

As recently as 25 years ago, there were over 6,300 savings and loan associations, with about 1,600 branch offices. Most associations at that time were single office operations, serving savers and borrowers in only one local market. Commercial banks were also mostly single market firms, with the most notable exceptions being the large California branch banking organizations.

The savings and loan industry has changed considerably in a quarter of a century, and now there are only about half as many associations. On average, however, the typical association is still relatively local in nature with only five branch offices. While an average ratio of five branches per institution doesn't suggest widespread branching, it is higher than the banking industry's average of less than three branches per bank.

As compared to commercial bank branching, thrift institution branching has generally not been as restricted by legislation and regulation. On the national level, savings and loan association branching has been subject to regulatory control, rather than to the statutory constraints of the McFadden Act. The thrift regulators, however, have frequently adopted equivalent branching restrictions. Many states have provided greater expansion powers for their thrifts than for their banks, a difference that has been a source of some irritation to many expansion-minded bankers. Until the last few years, both industries were prohibited from interstate expansion. But now, statutory changes and new regulations are laying the groundwork for what will become a system of truly nationwide depository institutions.

The Causes of Change

After all those years of branching restrictions, what is causing this current rush to lower the barriers to interstate activity by banks and thrifts? There are probably other factors involved, but I will only mention a few of what I consider to be the major forces for change.

The thrift industry's financial crisis in the early 1980s has to be considered one of the major factors contributing to the on-going change in interstate expansion policy. The need to find acquirors for financially troubled thrifts helped to change attitudes toward interstate financial operations.

After the difficulties encountered in resolving the Franklin National Bank failure in 1974, the Federal Reserve Board regularly recommended allowing out-of-state bank holding companies to acquire large failing banks. In the Franklin case, the regulators did not want the failed firm to be acquired by one of the other large New York banks because of antitrust considerations. The Board also recognized that in some states there would be no other in-state firm that would be able to take over a large failed bank.

While the interstate acquisition approach seemed reasonable, the crisis of the thrift industry was required to provide the necessary legislative impetus for enactment of the Garn-St Germain emergency interstate acquisition provisions. The law allows an out-of-state bank or bank holding company to acquire a failed bank having assets of over \$500 million. There are parallel provisions for an out-of-state bank or thrift to acquire a failed thrift. The thrift provisions do not include an asset size test, but do give priority to potential acquirors from within the thrift industry and from within the same state and neighboring states.

Even these minor moves toward interstate banking, however, were resisted by those opposed to any lowering of branching restrictions. While there have been many interstate acquisitions involving thrifts, the recent purchase of Park Bank in St. Petersburg by Chase Manhattan Bank was the FDIC's first transaction involving the purchase of a failed commercial bank by an out-of-state bank holding company.

In questioning during his Humphrey-Hawkins testimony last month, Chairman Volcker again suggested that allowing more branching would contribute to the resolution of failures. Especially in some of the mid-Western states, severe limits on branching make it difficult to find qualified buyers for failed institutions. Of course, if lenders had been able to spread their loan portfolios over larger geographic areas, fewer institutions would have had such high concentrations of agricultural and energy loans.

In addition to the problems of the thrift industry, other factors have contributed to the current trend toward interstate financial activity. One very important factor is the increase in the nationwide financial service offerings of nonfinancial firms, such as Sears. Unencumbered by the laws and regulations applicable to depository institutions, Sears is able to provide a variety of financial services without being constrained by state borders. Likewise, securities firms have been able to innovate with new financial instruments, such as the money market fund, and take deposits away from regulated institutions. Seeing their rivals operating free of both Regulation Q and geographic expansion restrictions lowered opposition to deregulation.

Resistance to change was also lowered by the development and spread of various techniques that allow a firm to compete in markets in which it

has no deposit-taking offices. The formation of multimarket ATM networks, the use of toll-free telephone lines to arrange deposits and the opening of loan production offices are examples of ways in which institutions have been able to provide services outside the area served by their branch offices. These innovations led to a recognition that institutions were not being kept out of markets by the branching laws.

Finally, it appears that many, but not all, of the traditional opponents of interstate expansion have accepted the inevitable. Rather than fight against all change, many now focus more on trying to shape the new interstate laws to maximize their opportunities in a less regulated environment.

At the state level, there appears to have been a massive shift in opinion, at least toward regional interstate banking. States, such as Illinois, that have restricted intrastate branching and multibank holding companies are now adopting regional interstate banking laws. Already 25 states and the District of Columbia have passed some form of interstate banking statute. Other interstate expansion laws are likely this year. There is certainly great momentum for geographic deregulation on the state level, even though the Congress has not yet changed the national laws.

What Can Interstate Operations Do For the Thrift Industry?

I would like to take a few minutes to discuss some ideas relative to the potential impact of interstate branching on the savings and loan industry. What gains can you expect from changing the laws in order to allow nationwide thrift expansion?

I would preface my remarks on this subject with the general statement that the thrift industry's return to financial health depends largely on a continuation of the lower interest rates of the last year or so, sound lending policies and access to the market for new capital. Lower interest rates and higher quality loans will produce the earnings growth necessary to rebuild capital and attract equity investors. In addition, the industry must restore its public image. The long series of failures, regulatory assisted mergers, revelations of the unorthodox lending and investing policies of some thrifts, and scandals surrounding some of the failures have left the industry with a tarnished image. Restoring the image of the thrifts as safe places to save, where the prudential use of the depositors' funds is paramount, will increase business and lower the cost of funds.

Turning to the subject of interstate offices, the first and most important short run benefit is the opportunity for interstate acquisitions of troubled thrifts. In the Washington D.C. area, a Virginia savings and loan that had been operating with negative capital was recently acquired by a District of Columbia savings and loan association, and a Philadelphia thrift recently acquired savings and loans in both the District and Virginia. The opportunity to expand within a relatively attractive market made the buyers willing to take over very troubled firms. The interstate acquisition method of resolving failing thrift problems has probably saved the FSLIC a considerable amount of money over the past few years.

More interstate acquisitions can be expected, given that there are still many thrifts operating below the minimum capital standards necessary for sound operations and protection of the FSLIC insurance fund. If an out-of-state firm is able to take over these thrifts and

restore them to health at the lowest cost to the insurance fund, allowing these acquisitions is certainly a good policy.

Another positive incentive for acquisitions would be provided by the Federal Home Loan Bank Board's proposal to allow thrifts to branch into three additional states in return for acquiring a failing institution. Combining this new incentive with the current lower interest rates, sharply increased profits, and an improved equity capital market should continue the process of recapitalizing the thrift industry. As more firms build up their capital through retained earnings and new equity issues, they can serve as a source of strength to the firms that are too weak to ever regain their financial health on their own.

Second, not all thrifts have the ability to adapt to the new deregulated environment. Clearly, the thrifts of the future will have to provide more services. Different thrifts will adopt different strategies. Some will look very much like full commercial banks, others will be consumer banks, and others will be mortgage loan origination offices. In any event, selecting a role and developing the expertise to carry out the appropriate operating strategy will be more difficult. Firms will come into competition with a wide range of other institutions with similar objectives. For those that cannot adapt, or are not willing to adapt to the changed world, the appropriate strategy will be a merger with a more innovative firm. Interstate expansion provisions will maximize the number of potential buyers of those institutions.

But, these issues deal with the solution to short term problems. In moving to an interstate environment, we should be concerned with the long term impact of financial innovation. For example, interstate expansion allows for the diversification of sources and uses of funds. Dependence

on economic conditions in a very limited number of local markets can be reduced by a wider range of operations. But, while geographic expansion allows for diversification and some risk reduction, the cost of this approach has to be compared to the cost of diversifying through the secondary markets. For instance, the mortgage portfolio can be diversified either by opening new offices in an area where there is a demand for mortgages, or by acquiring mortgage-backed securities. Both approaches can produce the desired risk spreading and their relative costs and returns should be carefully analyzed. Likewise, purchased money may be less expensive than funds obtained by opening costly branches in new markets. Therefore, the gains expected from geographic diversification may be achievable without physical expansion.

Second, interstate expansion allows banks and thrifts to gain whatever benefits accrue from larger size. However, it is not clear that there are always great benefits from increased size. The fact is that studies do not suggest that larger institutions are more profitable than smaller ones. As with banks, size may not be necessary for competitive survival and indeed may make such survival more difficult. This, however, is a decision I believe should be left to the market, as long as we recognize that size and mergers do not always spell success.

Third, we do not know what advantages will accrue to the nationwide branching firm, be it bank or savings institution. Given the mobility of the population, it would seem that there should be some advantage to the firm with offices in many markets. Perhaps there will be some marketing advantage in being able to advertise that you have an office in every state, just as United Airlines advertises that they serve every state. But, does this claim mean anything to an airline passenger,

and will it mean anything to consumers of financial services? Perhaps there will be some advantages, but studies in statewide branching states do not suggest that the statewide banks are more profitable than the single market banks.

Fourth, interstate expansion will permit all financial institutions to provide more convenient office locations for their existing customers. One of the most illogical results of the current system of law and regulation has been the inability of many institutions to expand within their natural market area. Until recently, banks and thrifts were not permitted to serve their customers in all three segments of the Washington, D.C. market, which contains parts of Maryland and Virginia as well as the District of Columbia. There was no real economic reason for preventing firms from servicing the needs of their customers regardless of whether they were at home in the suburbs or at work downtown. Yet, a 1969 proposal to allow interstate banking within the Washington area was overwhelming rejected. Of course, 16 years later the opponents of that proposal all jumped aboard the regional interstate banking bandwagon.

Finally, and perhaps most importantly, deregulation allows thrifts to go into markets that are not being adequately served by the existing institutions. There are still differences in the degree of competitiveness of various markets, and these differences can be profitably exploited by the entering institution. It will take some good market research to ferret out these markets, and many institutions will instead choose to enter big markets that are already highly competitive and attracting many other new entrants. While the big well-known markets may sound more glamorous, the profits may be waiting in places that no one has ever heard of! Look for the markets that are underserved; that's

where your entry can make a difference in the provision of financial services and can yield a worthwhile return on your investment.

Regardless of where entry occurs, it is clear that the trend is to create an environment of freer entry and institutional choice of places to operate. In time, the effect will be to reduce the variations in interest rates and the quality of services between markets.

On balance, my view is that interstate operations, either by banks or thrifts, have some advantages for consumers and depository institutions. They will provide opportunities and profits for well-run institutions, but will expose poorly run institutions to new competition and force them to either improve or cease operating.

General Concerns About Interstate Banking

I have supported lowering the barriers to interstate banking, and believe that the various types of depository institutions should all have equal expansion rights. However, few of the regional interstate banking compacts appear to provide for interstate savings and loan associations.

While I have advocated expanded interstate operations for banks and thrifts generally, I do have a few concerns. First, I would hope that those acquiring subsidiaries in new states have operating strategies that will result in the profitable management of their new acquisitions. Some of the acquisitions have been very expensive, and it is difficult to see how the new parent will be able to earn a reasonable profit on its investment. I would hope that potential acquirors are sensitive to the risks of overbidding for some of the more attractive acquisition candidates.

Second, I would encourage nationwide entry by banks and thrifts, rather than the regional banking compacts enacted by many states. The compacts do constitute an important liberalization by providing reciprocal expansion rights for institutions within a group of states. But, there should be a date on which states allowing entry from any other state would have to permit entry from all other states having out-of-state entry laws. National operations would permit more diversification of sources and uses of funds and would maximize the number of potential bidders for those institutions seeking to be acquired.

Third, the Federal Reserve Board has proposed limiting mergers among the largest institutions in the nation. This provision, which is contained in the interstate banking bill endorsed last year by the House Banking Committee, would limit the development of aggregate concentration. Perhaps most important in that respect, controls on large mergers and acquisitions would prevent an increase in the number of institutions that would be considered to be too large to fail. The experience with Continental Illinois demonstrated that a large bank failure can be averted without losing the beneficial discipline of the marketplace on its owners and managers. But, the stability of the banking system would be more easily maintained if no bank were so important that its failure would be viewed as a threat to the financial system. Thus, restricting the proportionate role of the largest institutions may have some value.

Finally, I would prefer to see interstate expansion result from a clear legislative mandate, rather than from the formation of nonbank banks. The nonbank banks add a new type of institution to the system, and may present problems that we have not yet considered.

The Board has attempted to restrict the nonbank bank movement, but the courts have clearly vested decision-making responsibility with the Congress. The policy adopted by the Congress and the President will influence both interstate expansion and the degree of separation of banking and commerce. Those who believe that financial institutions are special and should be separate from commerce should work for legislation banning nonbank banks. Alternatively, if you believe that depository institutions should not be treated as special, then nonbank banks will lead to the breakdown of the barriers between deposit-taking, investment banking, and all other types of businesses.

There is certainly a great deal of merit in the idea of permitting banks and thrifts to engage in an expanded range of financial services. For example, if the Congress believes that bank holding companies should be able to engage in activities beyond those presently permitted by section 4(c)(8) of the Bank Holding Company Act, that section should be amended so that diversification can proceed in an orderly manner under a new set of guidelines. Allowing a whole new set of institutions to develop through the nonbank bank route, without an opportunity to consider all of the implications, does not seem like the best approach.

I would prefer to see affiliations between banks and thrifts, rather than nonbank banks, as a vehicle for expanded interstate activity. The bank-thrift affiliation issue has been debated extensively over the years since the passage of the 1970 Amendments to the Bank Holding Company Act. Numerous public policy questions are involved and both the Federal Reserve and the Federal Home Loan Bank Boards have had reservations about cross industry acquisitions. The important issues raised include the special housing finance role of the thrifts, the separate regulatory

systems, the no longer relevant interest rate differential, and the different tax treatment of the two types of institutions.

The Board has recognized that operating a savings and loan association is closely related to banking, as is required by Section 4(c)(8). However, except for failing thrifts and other special circumstances, the Board has not concluded that there are net public benefits from the general acquisition of thrifts by bank holding companies. Over a series of decisions -- most notably the Scioto case in Ohio, the Citicorp acquisitions in Florida, California and Illinois, and most recently the Chase acquisitions in Ohio and Maryland -- the Board has allowed bank holding companies to acquire failed or problem thrifts. These acquisitions, however, were never without controversy. For example, many institutions opposed Citicorp's purchase of a thrift here in California.

Regardless of the questions raised in the past, I think that cross industry acquisitions should be allowed without consideration of the financial health of the firm to be acquired. While the discussion is usually in terms of bank holding companies acquiring thrifts, it should be made clear that thrifts could also acquire banks. Many of the old arguments against affiliations, such as the Regulation Q differential, no longer apply. On the positive side, these affiliations should benefit both types of institutions.

The major remaining issue is whether we are going to continue to have a distinct set of financial institutions oriented toward housing finance. While we maintained the housing orientation of the thrifts, the separation was more reasonable. Now, however, it appears that the differences between banks and thrifts are decreasing, and the arguments for keeping the thrifts separate have less force. If the thrift institutions are

going to have full commercial banking powers, they should be eligible for acquisition by bank holding companies. Likewise, they should be subject to the other regulations applicable to banks, such as those on affiliation with nonbanking firms.

Conclusion

To summarize my remarks briefly, I would reiterate my support for interstate expansion by both banks and thrifts. I believe that expanded branching powers would contribute to the resolution of the thrift industry's problems by enabling more institutions to bid for thrifts. In the longer run, we will see nationwide financial institutions; certainly we are a lot closer to that point than we were just a few years ago.

I would prefer to have progress in this area come about through statutory change, rather than through the nonbank bank route. Finally, if thrifts are to exercise all bank powers, we should rethink the past barriers to bank-thrift affiliations, as well as the other differences in regulatory treatment that have developed over time.