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THE PROSPECTS FOR INTERSTATE BANKING

Remarks by

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before

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I am pleased to be here today to discuss the propsects for interstate banking. We have been reading a great deal about this topic in the press, especially since the release of the Carter Administration's Report on Geographic Restrictions on Commercial Banking in the United States. Judging from the questions we are asked, it seems many bankers are assuming that interstate banking is just around the corner. However, it is not obvious that any great legislative changes are coming in the near future, and I will suggest my reasons for this opinion after discussing some of the key factors in the interstate banking debate.

I think that it is important to start by acknowledging that there are now a host of banking activities conducted on an interstate basis for corporate customers and consumers. Large business loans have usually been negotiated without regard to the location of the borrower or lender; large corporate deposits tend to flow along with the business loans. Consumer installment lending and mortgage lending are conducted on an interstate basis by both independent and bank holding company affiliated finance companies and mortgage bankers, and by retailers and nonfinancial companies as well.

In addition, two court decisions in 1980 expanded the range of permissible interstate banking activities. First, the U.S. Court of Appeals in the District of Columbia supported the Comptroller of the Currency's 1966 ruling that allowed national banks to establish loan production offices without regard to state branching laws. In supporting the Comptroller against the Independent Bankers Association, the Court ruled that interstate loan production offices were legal as long as they were not operated as *de facto* branches. In the second case, the Supreme Court ruled that Florida

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had discriminated against Bankers Trust Company of New York by outlawing investment advisory subsidiaries of out-of-state bank holding companies. The 1980 Monetary Control Act, however, placed a moratorium on the acquisition of trust companies by out-of-state bank holding companies. That moratorium will end October 1, 1981.

Furthermore, under the 1979 revision of Regulation K, implementing provisions of the International Banking Act of 1978, Edge Act corporations were allowed to branch interstate. Previously, each domestic Edge Act office had to be a separate corporation. By allowing one corporation with multiple branches, the revised rules lower the cost of establishing and operating Edge Act facilities.

Thus, it is important to recognize when we talk about the prospects for interstate banking that it is already a reality for large classes of services and customers. Who, then, would be affected most by an expansion of interstate banking?

Clearly, it is those locally limited consumers and small business firms who cannot yet deal with banks on an interstate basis. It is that group of bank customers whose business lacks the volume or profit potential to justify interstate search costs on the part of either the banks or the customers. It is the customer for whom convenience of bank office location is important. It is the business firm without a well known national credit record. These are the users of bank services that potentially would be most affected by any move toward interstate banking.

What could possibly be gained by allowing bank, or bank holding company, expansion on an interstate basis? The first potential gain is an increase in the number of competitors in local banking markets. According

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to economic theory and empirical research, high concentration in banking markets is usually associated with high prices of bank services. A survey of the literature by the Board's staff determined that 30 out of 39 empirical studies published between 1959 and 1977 found a statistically significant, but quantitatively small, relationship between bank market structure and bank performance. The inference we draw from this work is that by allowing new competitors to enter banking markets, we would hope to reduce concentration, lower prices somewhat, and improve the quality of bank services.

The second potential gain from a relaxation of present branching rules is an increase in consumer convenience. For example, millions of people, especially along the East Coast, live in "natural market" areas that are artificially divided by state boundaries. People working in Washington, D.C. may live in the District of Columbia, Maryland or Virginia. Those commuting into the city for the day must bank near home in the evenings or on Saturday, or do their banking in the city, or maintain accounts in both a District of Columbia bank and a suburban bank. Clearly some form of interstate banking would serve the convenience of these people. In 1969 the District of Columbia Bankers Association backed a proposal to allow reciprocal banking between Maryland, Virginia and the District. Hearings were held in the United States Senate, but opposition, especially from Maryland and Virginia bankers, resulted in defeat of the bill in committee.

Last year the Federal Home Loan Bank Board proposed allowing savings and loan associations to branch within the metropolitan Washington area. Branching by Federally chartered savings and loan associations is governed by Federal Home Loan Bank Board regulations, rather than by statutes. The general regulation is being held up pending analysis of the Carter

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Administration's geographic expansion report, but the Federal Home Loan Bank Board has now begun to authorize the acquisition of failing S&Ls across state lines. In the discusssion of that proposal, some urban groups argued that the deposits of city residents would be used to finance housing expansion in the affluent suburbs. The suburban savings and loans were telling their customers that their savings would be used to rehabilitate downtown Washington. How could both sides lose funds? The natural market-dictated reality of the situation is that deposits and mortgage loans have always flowed between the various jurisdictions in response to supply and demand factors. Because of commuting patterns, suburban residents probably hold more funds on deposit in District savings and loans than District residents have on deposit in suburban associations. However, because of the more rapid growth of suburban housing, suburban residents probably obtain more mortgage loans from District savings and loan associations. In any event, the argument that we do not want "our" money to finance "them" seems not to be a valid argument against interstate banking. If money had state names on it, "our" interest rates would normally be different from "their" interest rates. As you well know, money flows tend to equalize returns, in spite of institutional obstacles.

A third potential gain is to bank stockholders. A change in interstate banking laws would increase the number of potential purchasers of small banks and expand the market for local bank stocks. Instead of only accepting merger or acquisition bids from other banks in its state, a small bank would have the option of selecting its merger partner on a national basis. Likewise, the managers of large banks would employ the

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stockholders' funds in banks on a national basis. Under present law, the range of possible bank investment opportunities is limited to potential in-state acquisitions.

The fourth, and perhaps most important, of the advantages of interstate banking is the impact on bank performance of the threat of new entry. What competitive force could be greater than the thought of Bank of America or Citicorp opening a branch next door? The existence of the threat of new entry may be the most valuable feature of interstate banking. Many banks now operate free of the fear of new entry into their markets; and this threat of potential new entry may provide greater incentive for good performance.

To be realistic, even if the law were changed tomorrow, few places other than major urban areas would experience out-of-state entry in the immediate future. Even the largest banks cannot establish great numbers of branches overnight. If nationwide coverage became an objective, it would take years to accomplish. Yet, the knowledge that these large firms were looking for highly profitable banking markets would be an incentive for the provision of better services at lower prices.

While there are potential gains from interstate banking, there are also potential risks or losses involved in the transition. I would like to discuss two potential risks: the threat to the survival of small banks and the threat of rising aggregate banking concentration. I will argue that the small bank survival issue does not warrant the degree of concern that is often expressed, while the rising banking concentration issue is of greater concern.

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Let me start with the small bank survival issue. Can a small independent bank compete with nationwide banking firms? Will interstate banking result in the failure or forced merger of the small community bank? I'd like to say at the outset that I would not like to see bank expansion laws changed in any way that would lead to the elimination or significant weakening of the competitive position of the nation's smaller banks. However, there is no credible evidence that I know of to suggest that well-managed small banks cannot survive in competition with larger banks. Small banks survive in conditions of statewide branch banking today and should continue to do so in an environment of interstate banking.

Studies of bank costs do not find advantages for large banks of a magnitude that would suggest that small banks are doomed. A recent study by the Board's staff compared the performance of small and large banks in metropolitan areas. That study indicated that in 177 of 271 metropolitan areas, small banks had a higher average return on assets than large banks. Small banks, however, had a lower rate of return on capital in 178 of 271 metropolitan areas, reflecting the fact that small banks typically have higher capital ratios than large banks. Relative to large banks, the study also found that small banks tended to have higher deposit growth rates and noninterest expenses, but lower interest expenses. As expected, the large banks hold proportionately more commercial and industrial loans and proportionately fewer consumer type loans.

Looking at the rates of return earned by South Carolina banks in 1980, we find that same pattern. The banks under $25 million of assets had a higher return on assets (1.56%) than the banks with assets over $250 million (1.08%). The larger banks, however, earned 15.50 percent

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on equity while the smaller banks earned 13.04 percent on equity because of the leverage difference.

Without going into all of the comparisons in the study, the results do not support the fears of those who believe that small banks cannot survive in a deregulated environment. The prophets of small bank doom, although receiving considerable press attention, have provided no evidence to support their position.

The evidence on small bank survival does not mean that the number of small banks would not decrease under a regime of interstate banking. Many banks may prefer to sell to a larger organization rather than operate in a more competitive environment. But, the key point is that we see no great economic pressures that would force small banks to sell or fail.

Next, I would like to turn to what I think is an important danger in considering a move to permit interstate banking. There is a very real threat of rapidly rising banking concentration resulting from large bank mergers. I don't think that anyone wants a banking system composed of five or ten large banks. Yet, it seems that few banks regard the introduction of interstate banking as an opportunity for <u>their</u> expansion. Rather, most instantly assume that their bank will become part of a nationwide system formed by a larger institution. Surely someone besides the largest banks would be able to expand on a multi-state basis!

A recent article in the <u>American Banker</u> mentioned several southern and southwestern bank holding companies that would be likely acquisition candidates in the formation of interstate banking systems. For example, Southwest Florida Banks, a $900 million bank holding company, was recommended

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because of its location and earnings growth record. Some other acquisition candidates cited included: Hibernia, assets of $968 million; First New Mexico, assets of $1.2 billion; First Oklahoma, assets of $1.7 billion; and Zions Utah, assets of $1.5 billion.

All of these banks were praised as having growth potential, good earnings records and strong management. These are not the types of banks that I would want to see disappear by merger, nor would I expect such an outcome to have a high probability. If interstate banking means that a few very large banks are going to buy all of the strong, well-run community and regional institutions, then I think there is little to be gained from changing the present laws. I cannot see any increased economic efficiency or consumer gains resulting from replacing hundreds of strong local and regional banks with another thousand branch offices of a few giant institutions.

A banking system dominated by a few giant nationwide firms, while offering no great increase in economic efficiency, presents the danger of an excessive concentration of banking resources and does not conform with traditional American banking policy. Since at least 1832, when the Congress failed to recharter the Second Bank of the United States, American public policy has been oriented towards preventing the concentration of banking resources. In my judgment, this policy should continue.

Some might argue that existing antitrust laws would prevent excessive aggregate concentration. But, the Justice Department has been able only to block anticompetitive mergers between banks in the same market. Under a system of interstate banking, however, most mergers would be between banks in different markets, different states or different regions of the country.

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The present legal status and required burdens of proof in potential competition cases are still in doubt. The Justice Department has not been successful in any of the potential competition cases it has brought to court. While the doctrine of potential competition is hard enough to apply in a system without interstate banking, the difficulties would be compounded by interstate banking. Therefore, I would argue that any interstate banking legislation should contain some strong provisions to prevent mergers that would result in the rapid consolidation of the banking industry.

Now, I would like to consider briefly the three major interstate banking recommendations of the Carter Administration's Report. First, it was recommended that EFT terminals should not be subject to brick and mortar branching statutes. A lesser degree of regulation should allow the development of EFT in response to free market forces that will provide this new type of financial service in a manner reflecting the needs of the public. Given time for development, EFT systems would be able to provide greater public convenience at a lower cost to the financial institutions. No evidence has been developed to suggest that a lesser degree of regulation would harm competing institutions or result in the dominance of banking markets by large firms.

Second, the Report recommends permitting the acquisition of a large failed bank by an out-of-state bank holding company. For several years the Federal Reserve Board has recommended that Congress make this change in the Bank Holding Company Act. Small bank failures present no regulatory problems because numerous larger in-state banks normally have

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the financial ability to acquire the failed bank. Since the market share of the small bank is usually low, the acquisition of the small failed bank by one of the largest organizations in the state normally presents no antitrust problems.

On the other hand, the failure of a very large bank presents both financial and antitrust difficulties. Assume a hypothetical state in which the largest bank is failing. This bank holds 25 percent of total statewide deposits and is an important competitor in all major local banking markets. The second largest bank is also a statewide competitor and holds 15 percent of total state deposits. The third largest firm has 8 percent of state deposits; the remaining firms are much smaller. Even assuming substantial FDIC assistance, the second largest bank would experience considerable difficulty in absorbing the operations of the largest bank. But, let's assume number two can absorb number one. This acquisition would leave the merged firm with 40 percent of statewide banking deposits and the firm would clearly dominate the state's major banking markets. The Justice Department and the regulatory agencies would have great difficulty in accepting a merger that left one bank with a 40 percent state deposit share.

What alternative is available at this point? Banks from other states are barred from bidding for the failed bank. The only legal pro-competitive alternative is acquisition by a foreign bank. This situation is not equitable to either the potential bidders in other states, who cannot bid, or to the FDIC, which might receive a higher purchase premium if the pool of eligible bidders were expanded.

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The banking industry has indicated its dissatisfaction with the existing and potential geographic expansion rights of foreign banks. There has not, however, been a similar expression of sentiment for proposals to allow interstate acquisitions of failed banks by domestic bank holding companies. So far the resistance to interstate banking has dominated dissatisfaction with foreign bank expansion powers.

I continue to believe that the proposal allowing interstate acquisition of failed banks, as proposed to the Congress by the Federal financial regulatory agencies last year, is a good idea and should be supported by the banking industry. Hopefully, it will never have to be used, but we should be prepared to deal with such situations before they develop.

Third, the Report advocated a gradual relaxation of the prohibition against interstate bank holding company acquisitions. The decision to recommend bank holding company expansion, rather than interstate branch banking, was made largely in the interest of preserving the dual banking system. Bank holding company interstate expansion would not preempt state branching statutes or result in the conversion of state banks to national banks. On a practical level, state supervision of a bank with branches in many states would be complex. With interstate holding companies, subsidiary banks would continue to be regulated in the current manner. State regulation of banks owned by existing grandfathered interstate bank holding companies does not seem to have presented any unique problems.

I was pleased to see that the Report did recommend limitations on interstate expansion in order to prevent rising aggregate concentration. The specific limitations mentioned were limits on market shares that could

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be acquired and limits on the number of states that could be entered by any one bank holding company.

What are the prospects for change in the near future? While there is a great deal of discussion of the subject, I do not expect to see any really important movement for a few years yet. Let me quickly outline some of the reasons for this view.

First, is there a legislative constituency for this proposal? Other than a few of the very largest banks, I haven't heard many bankers demanding interstate banking legislation. Surely most banks would oppose the legislation because of the threat posed by outside entry. Turning to other groups, this is not an issue that has great consumer group appeal; I would guess that most of the consumer organizations would be against it because of a fear of large bank expansion. Large business firms already have access to national credit markets and are not likely to be affected much one way or the other. Thus, I don't see any strong legislative support for change.

Second, the fact that our very limited proposal to allow out-of-state holding companies to acquire large failed banks could not gain Congressional approval, suggests that, outside of a financial crisis, a general interstate banking plan would not have much of a chance at the present time.

There are a couple of wild card possibilities that could result in some change in the opposition to branching. On the state level, the Federal Home Loan Bank Board now allows federally chartered savings and loan associations to branch statewide in all states. With expanded powers, greater branching privileges and the Regulation Q differential, the S&Ls

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may become more aggressive competitors of banks in unit banking states. Those who have resisted branching in the past may reconsider if statewide savings and loan associations have some success in enticing away customers by offering the same services at more convenient locations. This factor doesn't affect the interstate banking issue directly, but it may indirectly reduce the number of bankers opposed to branching.

A second wild card is the developing competition for banks between state governments. South Dakota and Delaware have revised their laws to attract out-of-state banks to locate facilities in their states. Perhaps this kind of competition, largely taking the form of offering incentives, will eventually create opportunities for reciprocal interstate banking agreements. The Federal statute prohibiting interstate bank holding companies does allow individual states to determine for themselves whether to permit entry by out-of-state holding companies. However, up to the present time, only limited use has been made of this provision.

Seven multistate bank holding companies now exist. The largest of these is Western Bancorporation, which has subsidiaries in 11 western states. Among them, these seven companies have subsidiary banks in 24 different states. Of these 24 states, only Iowa allows new acquisitions by an out-of-state bank holding company; Iowa only permits new acquisitions by the one holding company which had Iowa subsidiaries in 1956 when further multi-state expansion was prohibited. Iowa also has an 8 percent cap on the share of total state deposits which can be held by any one bank holding company.

While I have mentioned these two wild card possibilities, they are clearly long shots. For the foreseeable future, I doubt there will be any

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change in current law and five years from now you may well have another speaker discussing the prospects for interstate banking.

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