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INTERSTATE BANKING: PROSPECTS AND PROBLEMS

Remarks by

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before

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It is a pleasure to have this opportunity to meet with you and discuss the gradual transition to interstate banking. While the pressures for change seem to be increasing, most of us would probably agree that the next Congress is not likely to authorize unlimited interstate banking. Even Congressional approval of regional interstate banking is in doubt. Its fate will depend on the outcome of the court challenges to state regional banking laws, and on the achievement of a compromise on other provisions of a broader banking bill.

While we may not have full interstate banking in the near future, we certainly do have an abundance of banking services provided on an interstate basis. Only full retail deposit-taking powers and the ability to provide all services through one subsidiary are needed to make interstate banking a reality. Since many of you have been in the forefront of the effort to provide banking services across state lines through nonbank subsidiaries, Edge Act corporations, loan production offices and grandfathered banking offices, I do not have to spend much time discussing ways in which interstate banking is conducted. I would merely point out that a 1983 study by the Federal Reserve Bank of Atlanta found over 7,800 out-of-state offices of banking organizations.

In addition to those provided through these 7,800 offices, many other services can be provided on an interstate basis without a physical presence in the market. Correspondent banking and many business services are in this category. Even some consumer products, such as credit cards, are now provided interstate without a banking office being required. For some services, the toll-free telephone line and the ATM have become acceptable service delivery systems. A lesson was learned here from the success of the money market mutual funds.

Now we have the nonbank bank as the newest method of interstate expansion. The institutions represented in this room probably account for nearly all of the pending applications to establish nonbank banks. As Chairman Volcker's letter to the Congress makes clear, our decision to approve nonbank bank applications was made reluctantly. While all of the Board members would probably favor some form of interstate banking, we are all opposed to allowing change to come about through this loophole in existing law.

Although the Board is approving nonbank bank applications subject to prohibitions on tandem operations, we would continue to warn the industry of the risk of having to divest these subsidiaries. The Congress has made its intentions known and those who assume that the cutoff date for grandfathering will be changed are taking a major risk. Since everyone has been warned prior to establishing their new subsidiaries, the case for grandfathering is not as convincing as it was in 1956 and 1970.

While interstate banking should be considered in the process of closing the nonbank bank loophole, that approach does not seem likely. Therefore, in the short run, changes in bank geographic expansion powers will be the result of state initiatives. The 1985 state legislative sessions will probably result in several additional states permitting some form of interstate expansion. I, myself, would prefer a national approach, but it seems clear that the Federal government needed — and still needs — pressure from the states to remedy this constraint on banking. Like NOW accounts, state action on branching will induce changes that would otherwise have taken too long to attain. Let me expand on my thoughts on regional interstate banking for a few minutes.

As an economist, I welcome the removal of restrictions on entry into new markets. Entry restrictions often serve only to perpetuate the existing division of market shares, regardless of how well or how poorly the market is being served. While we all may prefer to operate without competition or the threat of competition, no better force has yet been devised to assure good performance.

Having endorsed freedom of entry and the removal of entry barriers, I want to mention some of the problems that I see developing in the regional interstate banking movement. First, most of the actual and planned new entry involves mergers between large banking organizations. The trend is toward regional consolidation. Relatively large banks, capable of being lead banks of regional organizations, have instead become subsidiaries of even larger banks. Indeed, the merger of large regional banks appears to be the goal of the regional banking movement.

These mergers are defended in a number of ways that I do not find completely convincing. Will the merging banks, in fact, achieve economies of scale and scope? There is no empirical evidence to suggest that such economies exist. What evidence there is suggests that economies of scale are quickly exhausted. Those who believe there are economies of scale provide no evidence to support their claims. Each new or prospective change in the banking industry brings new visions of efficiencies that will benefit the large banks and doom the small banks to failure. After decades of hearing these claims, we still have thousands of very profitable small banks. Thus, I do not see the economic foundation for many of the large bank mergers.

The other justification that I frequently hear is that the regional banks must merge in order to compete with the money center banks when full interstate banking is eventually permitted. Again, there is no evidence that size is necessary for survival or that a bank must be all things to all people in all markets in order to be profitable. The argument that size is necessary to survival would result in a system composed of only a few very large nationwide banks.

Too often the argument for regional interstate banking sounds like "Let me absorb banks throughout my region so that I can be an attractive acquisition candidate when nationwide banking is allowed." Regional interstate banking may reduce the number of bidders, and hence lower the premium paid to the acquired firms by the acquiring firms. Therefore, it may become a boon to the large regional acquirors that are motivated to set themselves up to be future acquisition candidates or to become "large enough" to remain independent. That is to say, regional banking may be desired, or turn out to be, a subsidy to the larger regional banks.

The experience of Maine, the first state to adopt an out-of-state bank entry law, is illustrative of the value of maximizing the number of potential entrants. Rather than limiting entry to New England banks, many of which were already competing for business loans in Maine, the state was opened on a nationwide basis. Two of the first entrants were medium-sized bank holding companies from Albany, rather the expected major Boston and New York City banks.

While the Supreme Court will eventually decide the fate of regional reciprocal interstate banking, I hope that we will quickly pass through that stage of evolution and move to full interstate banking. Maximizing the number of potential bidders for exiting banks and maximizing the diversity of new entrants into markets should result in a better long run banking structure.

In this period of transition we need to be concerned about the long run structure of the banking industry. While reexamining the old rules, we must attempt to look well into the future and assess the long run impact of proposed changes. In this regard, I would raise two questions. First, do we need to be concerned about small banks? Second, do we need to be concerned about the nationwide concentration of banking resources? I would like to take a few minutes to examine each of these issues.

The small bank question does not appear to be a serious problem, although the small banks have the same fears about regional banking that the regional banks have about nationwide banking. The empirical work on small bank survival does not suggest major problems resulting from the continued deregulation of the banking industry. The Board's study of 1983 bank profitability, published in the November 1984 issue of the Federal Reserve Bulletin, suggests that small banks appear to have suffered somewhat from deposit deregulation. Money market deposit accounts increased their cost of funds, but large banks substituted MMDAs for purchased money and lowered their cost of funds. In addition, small banks have been less aggressive in pricing their services. In spite of these expected problems, the small banks continued to earn a higher rate of return on assets than the large banks. The comparative rates of return on capital were slightly in favor of the large banks, but the difference will narrow in coming years as large banks increase their capital to levels closer to those of the small banks.

I do not foresee any forces that would suggest problems for the smaller banks. They can exploit their knowledge of local market conditions, and while they may not have the resources to develop new products or operating systems, there are plenty of vendors to assist them in the delivery of high quality banking services. Competition will be tougher than in the past, however. Merely holding a banking charter will not be a guarantee of profits. But, those willing to adapt to market conditions and meet the needs of the marketplace will continue to do well, even in competition with large nationwide firms.

Even though many small banks will be acquired, most of the acquisitions will be by choice and not by necessity. I doubt that the total number of banking organizations will decline to the extent predicted by some forecasters. The major declines in the bank population will occur in those states that do not yet have full intrastate branching. Illinois and Texas, for example, each still have over 1,000 banking organizations. Nearly 30 percent of all banking organizations are in Texas, Illinois, Kansas or Missouri. One half of all banking organizations are in only nine states. Greater intrastate branching will decrease the number of banks, whereas interstate banking will increase national deposit concentration.

In estimating the number of banks likely to exist at some future date, we should not overlook the fact that new bank formations still continue at relatively high rates. Banking is viewed as a profitable industry, and as long as there are markets where entrepreneurs perceive the prospect of profits, new banks will be formed.

While small bank survival is probably not a problem, I am more concerned about the second issue that I raised, the question of aggregate concentration. Aggregate concentration, or the percentage of total nationwide deposits held by the few largest firms, is an issue that transcends pure economics and goes to more deeply held traditional American concerns. The prevention of financial concentration is one of the bases of American banking policy. In formulating an interstate banking policy, we must decide whether we want to reaffirm this objective or permit a greater degree of nationwide concentration of banking resources.

Some would argue that there is no need to worry about aggregate concentration. They reason that the number of firms in the banking industry is so large that there is no reason even to discuss the issue. Yet, I do not think that that attitude is correct. The top 100 banking organizations controlled 53.9 percent of domestic banking assets at the end of 1983, an increase of over five percentage points since 1978. If we do not control interstate mergers between large banking organizations, deposit concentration on the national level will increase ever more rapidly. The overwhelming proportion of the banking industry's assets would be held by a very few extremely large nationwide firms. There would still be thousands of other banks, but they would collectively hold only a small fraction of total deposits.

Some observers also argue that banking concentration would not increase because there are no substantial economies of scale in banking. This argument also misses the point. The lack of sizeable economies of scale has not prevented increased state deposit concentration in those states that permit statewide branch banking. Clearly, there are factors other than economies of scale associated with the mergers and acquisitions that occur after a state liberalizes its branching laws.

Would the antitrust laws prevent the growth of nationwide banking concentration under a regime of interstate banking? This seems unlikely because, at least initially, banks headquartered in different states would not be considered as competitors in the same local banking markets. The antitrust laws are more effective in dealing with mergers within markets than with mergers between firms operating in different geographic markets.

Therefore, if the Congress wants to maintain the historically low degree of nationwide banking concentration, interstate banking legislation should be accompanied by some restrictions on large interstate bank mergers and acquisitions. There are many ways that interstate banking legislation could incorporate concentration limitations. We have studied many possible formulas, such as prohibiting mergers among the 100 largest firms. A simple system based on the size of the acquiring firm would seem best. Nearly all banks not competing in the same markets would be free to merge interstate without limitations. The largest banks, however, would face increasingly severe size restrictions on their acquisitions as their nationwide share of banking assets increased. To be sure, it seems clear that due regard will have to be taken of the increasing competition banks face from other depository and nondepository financial institutions. Regardless of the specifics of the plan, I would hope that some fair and workable system for maintaining a deconcentrated financial system would be developed by the Congress.

As a final topic, I would stress the need to maintain the safety and soundness of the banking system in the process of moving into the interstate banking era. Interstate banking has the potential to decrease banking risk, but it can also lead to an increased risk. Clearly, the ability to expand geographically should allow risk reduction opportunities. To the extent that different regions of the country are subject to different economic forces, a diversification of consumer and business loan portfolios is desirable. On the other hand, the consequences of the rush to enter the energy lending business should have taught us something about careful diversification.

The other risk that is frequently cited in discussing interstate banking is the danger that the acquiring firm will, in its eagerness to acquire an attractive entry vehicle, pay too high a premium for the target firm and dilute its equity position. I think that the market is able to impose its discipline on firms that overbid for acquisitions. The costs of equity and debt funds will increase as the market perceives the added risk and the dilution of the stockholders' equity.

Still another risk that policymakers must consider involves deposit insurance and related issues. If there is in fact a cutoff over which banks are too large to let fail, the growth of bank size through interstate mergers may increase the number of institutions for which market discipline is blunted by public policy concerns. I am reasonably optimistic that policy-makers have options that can bring the same types of penalties to the large banks as to the small banks. But, there are problems and tradeoffs and recent events have made clear, I think, that this dimension of banking structure is ignored at our own risk.

The final risk factor that I will mention is also applicable to the current rush to establish nonbank banks. There is a danger that every-one will try to enter the same attractive banking markets. For example, 11 banking organizations have applied to establish nonbank banks in Phoenix, Arizona. While Phoenix is indeed a growing and attractive market, how many new banks can the market support all at one time? I am not suggesting that any of the new entrants will fail, or that the losses incurred by their parent organizations will cause their failure. However, I would feel fairly safe in predicting that not all of these new entrants are going to earn their target rate of return on their Phoenix subsidiary. For that reason, I would suggest that investments in new subsidiaries be limited, at least initially. I would also suggest that there are plenty of profitable markets that could use some new competitors; everyone doesn't have to go to all of the same places.

To conclude my remarks this morning, I would stress my desire for a fair, orderly, and safe transition to nationwide interstate banking. We must be concerned with both short run equity for the public and private interests involved and with the long run health and efficiency of the financial system. What we build in the next few years will be with us for many years, so we must design well. I thank you for inviting me to share my views with you and look forward to meeting you individually over time and working with you as we move forward.