PROGRESS TOWARD INTERSTATE BANKING

Remarks by

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before

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It is a pleasure to be here today to discuss the future geographic expansion of the banking industry. Events leading up to the passage of the Garn-St Germain legislation clearly point to a Congressional review of the McFadden Act and the Douglas Amendment to be a high priority item for the next legislative session. To some extent, we are living in a *de facto* interstate banking environment now.

As the regulator of bank holding companies, the Federal Reserve has its own perspective on the implications of change in the geographic scope of the banking business. I would like to touch on some of my personal concerns in today's remarks.

Interstate Banking Services Are Here Today

In discussing interstate banking, I think it is worthwhile to distinguish between interstate banking and interstate financial services. We have a little of the former and a lot of the latter.

Starting with interstate banking, the seven domestic multistate bank holding companies that were grandfathered by the Bank Holding Company Act of 1956 represent the most extensive example of current interstate banking. These seven holding companies have about $23.6 billion of deposits in banks in twenty states other than their home states. In some cases, their subsidiary banks are a minor factor in the host state's banking structure, but in three states they hold over 30 percent of total deposits and in nine states they hold in excess of 10 percent of total statewide deposits. With minor exceptions, these seven multistate holding companies cannot acquire additional banks outside their home state, but they can add branches in some of the states in which they already operate.

Until recent years, there had been little change in either federal or state statutes since the 1956 Act barred further interstate expansion unless acquisitions were specifically permitted by state law. In 1975 Maine became the first state to provide for entry by out-of-state bank holding companies. Because the Maine law was restricted to entry by holding companies headquartered in states providing reciprocal entry rights to Maine bank holding companies, there were no acquisitions under that law. In 1982, however, New York and Alaska passed laws allowing entry by out-of-state bank holding companies. New York, like Maine, requires reciprocity, but Alaska did not require reciprocal entry rights for Alaska bank holding companies. Although these laws are still relatively new, two New York holding companies have announced planned acquisitions in Maine and two Washington state holding companies plan acquisitions in Alaska.

Beyond these general acquisition laws, Iowa, Florida and Illinois allow bank acquisitions by those out-of-state holding companies that owned banks in the state before a certain date. Only a limited number of holding companies can expand under these grandfather provisions.

On the federal level, the Garn-St Germain Depository Institutions Act of 1982 allows the acquisition of certain failed institutions by an out-of-state organization. For several years the Board of Governors requested that the Congress enact legislation granting the regulatory agencies greater flexibility in finding procompetitive solutions to large institutional failures. The Garn-St Germain Act permits an out-of-state organization to acquire a failed thrift of any size or a failed bank with assets of at least $500 million. While the law establishes a statutory preference for in-state mergers of like institutions, the out-of-state option now has been clarified, to some degree.

Thus, while there is some interstate banking, it is limited in nature and, under current laws, does not allow for much future expansion. On the subjects of interstate banking and financial services, however, we find very rapid change and growth. Banking services are provided interstate even though all services cannot be provided as a package by a fully chartered deposit taking bank. While banks sometimes feel disadvantaged compared to their nonbank competitors, I would point out that neither banks nor their new competitors can engage in all aspects of the banking business on a nationwide basis. For example, bank holding companies have been able to expand the geographic scope of their activities quite considerably through loan production offices, nonbank subsidiaries such as finance companies and mortgage banking firms, Edge Act corporations and other means.

Turning from banks to nonbanks, the nonbanks are also providing some financial services on an interstate basis. The crisis in the thrift industry has resulted in several interstate mergers of savings and loan associations and of mutual savings banks. While these mergers provided merger partners for distressed firms, the net result was to create a few interstate thrifts. With the recent expansion of thrift powers, these multistate thrifts will do an interstate financial business not significantly different from banking. Like the grandfathered multistate bank holding companies, these multistate thrifts cannot continue to expand at their own option. Given the financial position of the thrifts, however, they will probably provide some, rather than all, banking services on an interstate basis.

The other competitors of the banking industry have the ability to provide a more limited range of bank services on an interstate basis. Like the banks, however, they cannot provide all banking services nationally. Merrill Lynch and other brokerage firms are free to offer money market mutual funds and a few other bank-type services, such as the Cash Management Account, on a nationwide basis. Sears offers a fund nationwide.

Given that banking services can be provided on an interstate basis, would a bank holding company need or desire a physical interstate presence? If we assume that there will be some deregulation of the bank holding company's product line and deregulation of interest rates by the 98th Congress, does the bricks and mortar presence of the bank mean as much as the presence of the other financial activities of the organization? It is becoming increasingly possible to expand a bank's deposit base without expanding its number of offices. The brokering of deposits is but one example of ways in which funds can be raised without the need for more branches. The introduction of the new "money market" account without any interest rate ceiling provides a competitive tool for deposits. Before Regulation Q ceilings, the California thrifts were able to attract money from other parts of the country by paying a higher interest rate. The mobility of brokered money became a supervisory problem of California authorities for some years. Brokered funds complicate your liquid asset management. Today, money market funds have accustomed consumers to dealing with an out-of-market firm, an "800 number." Banks will be able to obtain funds in the same manner.

In addition, banks are increasingly able to serve customers without a larger network of offices. The future growth of interstate automated teller machine networks and credit card networks will, if laws permit, provide part of the mechanism for dealing with retail customers. Wholesale customers can be served through loan production offices and commercial finance subsidiaries.

Finally, in spite of all the interest in the subject of interstate banking and the controversy that will be generated by its discussion, there are limits to the effect that a modest change in the law would have in restructuring the banking industry. Your ability to serve distant markets may be based more on technology than on brick and mortar expansion. Referring back to the seven grandfathered interstate bank holding companies, their market shares in the states in which they operate have not grown significantly over time. They do not appear to have any great competitive advantage over the other banks operating in those states. Also, we are not seeing any great rush to enter those states that now allow out-of-state entry. The pace of change in those states is much slower than predicted.

The Shape of the Future Banking System

Having briefly reviewed the status of interstate banking activity, I would like to spend a few minutes looking at what I consider to be one desirable future framework of the banking system. Essentially, the question is: What will the system look like ten years from now?

The optimum banking system of the future would provide the best possible banking and other closely related financial services at the lowest possible cost and without undue risk to the payments system. I believe that the best way to meet this standard is to permit the system to evolve so as to optimize competition, and thus consumer choice, in the provision of banking services. I use the term optimize competition to mean the maximum competition consistent with the need to maintain safety and soundness.

The way to facilitate a competitive system is to maximize freedom to enter new banking markets. Our banking system is becoming more competitive, but the Justice Department's recently issued horizontal merger guidelines indicate that 92 percent of non-SMSA counties and 53 percent of SMSAs are in the "highly concentrated" category. Even if the definition of the "line of commerce" were expanded to include mutual savings banks and savings and loan associations as they become closer competitors of commercial banks, the Justice Department might still consider

20 percent of all SMSAs to be highly concentrated. Competitive performance in banking markets would be optimized by allowing freer entry into markets and de novo entry is of course desirable. Entry through supervisory mergers will further competition.

I would hope that some lowering of interstate expansion barriers over time would result in entry into markets of many sizes. In ten years we will probably still find a mixture of varying size firms represented in most banking markets. Some large firms will have the desire and ability to expand over many of the nation's banking markets, but very few firms would have the capital or managerial resources to become truly national organizations in a ten-year period. More firms will and should be able to expand within their own market, their state, or their region. In each market there would be a mixture of large nation-wide firms, large local or regional firms and smaller local firms.

Why do I predict a mixture of different types and sizes of banks and forms of expansion? First a deconcentrated banking structure is traditional and unique to the United States. Our traditional preference for the wide distribution of economic power and financial resources and our legal framework would not permit the concentration of banking resources into a few large nation-wide banks. Market forces will not eliminate the regional banker nor the community banker. The studies of economies of scale in banking do not suggest that a bank has to be very large in order to be efficient. In the age of the core deposit, small community banks demonstrated clearly that they could compete with larger and more geographically diversified firms. In today's environment the well managed, community rooted bank will find its niche and maintain its market share.

I would not argue that there will be as many banks in ten years as there are now. But there probably will be more than most observers expect. Many small banks will choose to sell out to other banks or bank holding companies. However, it should be noted that even though many banks have been acquired in recent years, new bank formations have maintained a nearly constant number of banking organizations. In addition, the banking powers of the thrift institutions have been expanded by the Garn - St Germain Act and by the laws of states such as California and Florida. Many thrifts will become more complete competitors of banks.

Interstate banking will be limited by the need to preserve equity capital ratios at many large banks. In the next decade, it appears that the lack of equity capital will be the greatest barrier to both geographic and product line expansion by banking organizations. I doubt that the Board would look favorably on a large scale geographic expansion movement based on debt financing by those banks that are already under regulatory pressure to increase their equity base. The shortage of equity capital, along with the high multiples that will be demanded by the most attractive acquisition targets, likely will slow expansion activity.

The need for equity capital for geographic expansion will be added to the equity capital requirements for bank holding companies whose strategic planning involves product line expansion and deregulation. Expanding into new activities takes funds and adds to overall risk exposure. An increasingly sophisticated public will know that the bank and nonbank affiliates of a holding company system are "related." In a deregulated environment, a satisfactory capital structure will be thus important to ensure safety and soundness. New activities demand specialized management: the farther you move from classically commercial banking, the more complicated the supervisory process becomes.

Additional Hurdles to Overcome

Turning to the future, what is the prospect for further liberalization of interstate banking barriers? Some seem to think that we are on the brink of a repeal of either or both the Douglas Amendment and the McFadden Act, but we cannot overlook just how many opponents of change there are. Opponents argue that interstate banking would destroy the uniquely American dual banking system. Second, they claim that interstate banking would lead to a great increase in the concentration of American banking. I would like to spend a few minutes examining each of these topics.

Turning first to the question of the dual banking system, I think that the survival of the dual banking system depends in large measure on how an interstate banking system may evolve. Eventually Congress may permit national banks to branch on an interstate basis. The states would be free either to eliminate or maintain any present restrictions. If a state maintained barriers, a bank that desired to branch interstate would have to be a national bank. Because most of the larger banks, which would account for the bulk of interstate banking activity, are already national banks, there would not be a large number of conversions from the state systems. But, the net effect would be to tend to remove the remaining large banks from the state banking systems.

Compare interstate branching with a system of interstate bank holding companies. If the bank holding company were the interstate banking mechanism, the separate subsidiaries of the holding company could be examined in their host states, regardless of the home state of the parent holding company. Would a multistate holding company charter all its subsidiaries as national banks in order to minimize the number of regulators? The seven multistate bank holding companies provide a convenient test. Their subsidiary banks are composed of mixtures of state and nationally chartered banks. One multistate holding company has only 4 percent of its subsidiaries' deposits in state chartered banks, but another company has 100 percent of deposits therein. Thus, the evidence suggests that the charter decision depends on factors like broader powers.

Given its lesser impact on the dual banking system, the interstate bank holding company approach was recommended by the authors of the 1981 Carter Administration report on <u>Geographic Restrictions on Commercial Banking in the United States</u>. Although the report has been criticized by the advocates of the dual banking system, it was an attempt to preserve the dual banking system while facilitating interstate banking.

We must recognize, however, that any system of interstate banking will, to some extent, change the relative roles of the federal government and the states in the determination of state structure. Therefore, the issue is a political and philosophical question, as well as an economic issue, and the Congress must decide both questions.

While I think that the role of the states in bank chartering and supervision can be maintained under a system of interstate bank holding companies, I have greater concern with the second issue raised by the opponents of interstate banking, the threat of rising concentration.

If Congress allows bank holding companies to acquire banks on a multistate basis, the nationwide concentration of banking resources will tend to increase, offset by thrift and bank competition. The available evidence suggests that unlimited interstate expansion would increase the percentage of total banking resources controlled by the nation's largest banking organizations. Would this result in the deconcentration of local banking markets? Past patterns do not suggest that this would happen. Most likely, interstate expansion would take place via the acquisition of large banks, rather than by the formation of *de novo* banks or the acquisition of small banks.

There is considerable evidence to support this view. In anticipation of interstate banking, several large organizations have announced agreements for future mergers. These agreements are not between large and small banks, but are between the very large and the largest banks. The relaxation of state constraints on multibank holding companies produces the same conclusion. Most of the merger agreements announced in Pennsylvania, for example, involve combinations of the state's leading banks. Large organizations have preferred to merge with other large organizations, even when they both have had the resources and capabilities to become the lead bank of separate competing holding companies and to enter new markets on a de novo basis.

Thus, the evidence suggests that unlimited interstate banking would result in an increase in national concentration. Unless some system is devised to prevent this likely increase in nationwide concentration, the opponents of interstate banking may have sufficient allies to prevent any wholesale lowering of the current barriers by Congress. To what degree should interstate bank operation be brought to parity with thrift and nonbank competition?

Summary

To summarize, I believe we will evolve during the next decade to a partially interstate banking system that will preserve the dual banking system and that will not lead to a massive increase in the nationwide concentration of banking resources. The political process will produce the necessary compromises with the opponents of change and with those who are concerned about the preservation of a dual banking system and with thrift and nonbank competitive parity.

Though there may be some relaxation of the restrictions on interstate banking, I do not think that the change will have a truly revolutionary effect on the financial services marketplace. The evolution is already underway, driven by market forces. The current expansion of interstate banking services and nonbank financial services is serving as a transition between interstate services and interstate banking. In addition, there are many pressures from within the industry, the regulatory agencies and the general public that will restrain the pace of change. Thus, interstate banking will be an evolutionary process and will be only a part of the trend toward the homogenization of the financial services industry.

Finally, if I were to advise you on the best way to prepare for these changes, I would stress the fact that capital adequacy must be maintained in order to provide the flexibility to respond to change and to profit from the new opportunities that will be arising in this era of continuous change. I realize that the equity problem is not one that will be easily overcome, but I believe it is one that we must continue to address in order to ensure your viability as strong competitors in the marketplace and to satisfy our concerns in regard to the safety and soundness of the banking system.