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PROGRESS TOWARD INTERSTATE BANKING

Remarks by

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before

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I appreciate this opportunity to be with you to discuss the changing structure of the banking system. For those of us who have studied financial institutions over the years, these are exciting times. Change is taking place more rapidly than ever and developments in the next few years will shape the banking system for generations to come. This rapid change presents both opportunities and potential problems and dangers. It is my view--and my theme here today--that change should not be a product of legal loopholes, but should result from carefully formulated policies consistent with the long-term public interest.

My specific subject today is the always controversial topic of interstate banking. Interstate banking is governed by the McFadden Act and the Douglas Amendment to the Bank Holding Company Act. The McFadden Act of 1927 prohibits interstate branch banking. When the Act was amended in 1933, there was some consideration given to allowing national banks to branch nationwide, but this policy option was rejected. The McFadden Act was simply liberalized somewhat to grant national banks in each state the right to branch to the same extent that state banks were permitted to branch. State banking laws, therefore, determine the branching powers of both state and national banks.

Prior to the passage of the Bank Holding Company Act of 1956, bank holding companies were free to own banks in more than one state, and seven major domestic holding companies had extensive interstate banking operations. The company that is now First Interstate Bancorp was the largest of the multistate companies with bank subsidiaries in eleven western states. The version of the Bank Holding Company Act that was brought to the Senate floor was silent on the issue of interstate bank holding companies. Senator Douglas, concerned about the possible future concentration of the banking industry, amended the bill during debate to prohibit further interstate expansion by the multistate firms.

The Douglas Amendment did not require divestitures by the existing multistate companies, and provided that the states could enact legislation to permit entry by out-of-state bank holding companies. Other than for some minor exceptions, this provision went unused until Maine adopted its new banking code in 1975. The Maine law permitted entry by an out-of-state holding company provided that the holding company's home state extended reciprocal entry rights to Maine bank holding companies. Given that no other state had such a statute, the Maine law had no impact until New York adopted similar legislation in 1982. Now, eleven states have some form of interstate entry law, with more states expected to adopt similar legislation in the near future.

Currently, Maine and Alaska allow entry from any state without requiring reciprocity, New York allows entry from any state providing reciprocity, and eight other states require reciprocity and limit entry to bank holding companies headquartered in specified states. In the Northeast, all the New England states except Vermont and New Hampshire provide for out-of-state entry. In the Southeast, Georgia, Florida, Kentucky, and South Carolina have adopted legislation oriented toward a Southeastern banking zone. Outside the East, only Utah has joined the interstate banking movement.

Beyond these state laws, which I will come back to later, we have a second set of developments that potentially could lead to more interstate banking. In recent months, 38 major bank holding companies have filed applications to open 283 nonbank banks outside their home states. Given recent court rulings and the Board's subsequent decisions based on those rulings, it would appear that a bank holding company could operate interstate nonbank banks as long as those banks did not both accept demand deposits and make commercial loans. The Comptroller of the Currency, however, has placed a moratorium on granting national bank charters to these proposed partial service banks, pending Congressional action on the definition of a bank for purposes of the Bank Holding Company Act. The Comptroller has indicated his intention to approve such charters, absent a Congressional resolution of the bank definition issue. Granting nonbank bank charters to bank holding companies would quickly break down the remaining barriers to interstate banking.

The nonbank providers of financial services are a third source of pressure on the barriers to interstate banking. Many large thrift institutions and a few bank holding companies have expanded interstate by acquiring failing thrifts under the emergency interstate acquisition provisions of the Garn-St Germain Act. In addition, there are major new suppliers of banking services, such as Sears, Merrill Lynch, and American Express. These nationally-known firms are not bound by the barriers to interstate banking, or by most of the other laws and regulations governing banks, and are able to operate offices wherever they want. Indeed, many small rural banks fear competition from Sears more keenly than the threat of entry by large commercial banks.

Given these three developments---the state laws permitting out-of-state entry, bank holding company formations of nonbank banks, and the interstate operations of the nonbank firms---it is clear that we are at a crossroads in our thinking about interstate banking. We are faced with hard decisions that will determine the future of the American banking system. We could do nothing and allow the banking system to evolve on its own, but I think that course of action would fail to safeguard the public interest and would lead to serious undesirable results.

As I proceed, I will outline some of the facts and evidence on interstate banking and the policy measures that I believe are consistent with the long-run public interest. While not all the battles have been fought yet, I think the war is nearly over and interstate banking is inevitable. This does not mean that we will have nationwide banking this year or next, but it is no longer the remote future possibility that it appeared to be three years ago. Most banking services are routinely provided on an interstate basis. The nonbank subsidiaries of bank holding companies operate across state lines, Edge Acts can branch nationwide, correspondent banking services move funds between areas, loans are sold by banks, and deposits are moved in a variety of ways. Although interstate deposit-taking is still generally prohibited, the consumer banks and other nonbank banks can take deposits interstate as long as they do not both accept demand deposits and make commercial loans.

What is special about a state border that requires limiting a banking organization to one state? Why should my bank in Washington, D.C., be prohibited from having an office near my home in Maryland? Given that all of our conventional economic theory is based on free entry into markets as the method of maintaining a high level of competition, why should a bank from one state be prohibited from competing in all other states?

While the state barriers to bank expansion may conflict with the economic principle of freedom of entry, these restrictions have served some useful purposes. By preventing interstate expansion, we have maintained a relatively unconcentrated banking industry. Unlike other economically advanced nations that have only a few giant banks, the United States has thousands of banks, most of which are relatively small and operate in only one or a few markets. Even the largest bank in the United States holds less than 5 percent of total nationwide banking deposits.

While the concentration of nationwide banking resources has been limited by interstate banking prohibitions, high concentration in local markets has been constrained by the antitrust laws. If interstate banking were permitted, the antitrust laws would continue to prevent anticompetitive mergers within markets. But, interstate bank mergers and acquisitions among the largest banks would lead to increased nationwide banking concentration. Within a relatively few years, there would be a marked increase in the percentage of total banking resources held by the largest banking organizations.

At the moment, the ten largest banking organizations hold approximately 21 percent of total domestic banking assets and the 100 largest firms hold 54 percent of assets. While these percentages are not high relative to other industries or banking in other countries, it must be remembered that we are talking about the largest ten or 100 firms in an industry composed of over 12,000 organizations.

If we do not want the vast proportion of the banking industry's resources to be held by a handful of giant firms, we must take some preventative action when interstate banking is introduced. There are many rules of varying degrees of complexity that could be incorporated into an interstate banking statute. The simplest rule would be to prohibit all mergers among the 25 or 50 largest banking organizations. Those large firms could expand into new markets only on a de novo basis or by acquiring a smaller firm.

Alternatively, a legislative cap could be placed on the total share of nationwide assets that could be held by any one banking organization. For example, a rule could prohibit any organization holding more than 2 percent of domestic banking assets from expanding other than by the formation of de novo banks.

The form of the rule is less important than the principle involved. If we are to maintain a relatively deconcentrated and highly competitive banking industry, there must be some means of preventing large bank mergers. The existing antitrust laws do not provide an adequate means of preventing mergers between banks that are not currently competing in the same local banking markets.

While I have talked in terms of preventing an undue concentration of banking resources, I do not want to give the impression that this is the only aspect of interstate banking that must be considered. Therefore, let me briefly mention a number of other important points. First, would an interstate banking system meet our safety and soundness requirements? The existing evidence suggests that there is no statistically significant difference between the failure rates of banks operating under different bank structure laws. There have been failures of both unit banks and branch banks, independent banks and subsidiary banks of multibank holding companies. The evidence on safety and soundness is neutral, except for the greater difficulty of resolving a large bank failure. The larger the failed bank, the smaller the number of potential acquiring firms and the greater the resulting increase in the concentration of the banking industry.

Second, would a system of nationwide banking better meet the credit needs of the economy? There is no evidence that this would be the case. Our present system, characterized mainly by a large number of relatively small firms, is doing a very good job of allocating funds. In some cases, loans that could be handled by one very large nationwide bank have to be syndicated by a group of banks; but, while this may add to the costs of lending, it also spreads the risk among a larger number of lenders.

Third, would large nationwide banks be so efficient and innovative that small banks would not be able to compete? The existing empirical evidence does not suggest that there are any substantial economies of scale in banking, although many of the large banks dispute this evidence. While the large banks claim that there are economies of scale and scope, these efficiencies do not seem to be reflected in their profit statements. Studies suggest that, even in the major urban banking markets, small banks tend to earn higher rates of return on assets than their large bank competitors. Innovation also is not a function of size; the economics literature suggests that many innovations have come from smaller firms. For example, a relatively small savings bank developed the NOW account.

As a fourth question in this quick review of the evidence, would interstate banking increase public convenience? The argument used to be that interstate banking would make it easier for the traveler to obtain cash if his bank could have branches all across the nation. The shared nationwide automated teller machine networks are beginning to serve this function. However, it would be convenient not to have to establish a new banking relationship every time you move. Given the geographic mobility of the American population, each year millions of people who relocate change banks because they want to deal with a bank conveniently located relative to their home or workplace.

Finally, what effect would interstate banking have on the flow of funds within the nation? Many fear that allowing the entry of out-of-state banks would result in their money being moved someplace else to the detriment of their community. However, money moves to the place of highest return, other things being equal. It may move through the federal funds market, through the mail solicitation of deposits, or through the local bank's purchase of loans originated outside of the market. These examples simply illustrate the point that money is mobile and there is no system that could or should maintain a total correspondence between deposits generated in a market and loans originated in that market.

Competition is the ultimate guarantor of access to credit. If one set of banks is not meeting the community's credit needs, new banks will enter and profit by satisfying those credit needs.

This quick review does not indicate any overwhelming case either for or against interstate banking. The strongest plus factor is probably the expanded freedom to enter new banking markets; we would hope that over time, entry would increase the number of competitors in most markets. On the negative side, as I previously indicated, interstate banking does pose the danger of an excessive concentration of banking resources.

Having considered the evidence, let me evaluate the characteristics of the three forms of interstate banking that I previously described. I will begin with the two types of nonbanks and then discuss the regional interstate banking movement last.

The provision of banking services by nonbank and nonfinancial firms presents a problem of competitive equity. To use the standard phrase, the playing field is not level. Sears has some competitive advantages over the local bank. For example, banks cannot provide all of the financial services, such as real estate brokerage and insurance underwriting, that can be provided by Sears. At some point, Congress must draw a line between what is a bank and what is not a bank and determine what financial services can be provided by a bank. We cannot, however, define banking powers on the basis of what Sears or Merrill Lynch can do; some of their services may not be appropriate for firms that provide the essential banking services.

The separation of banking and commerce is a long-standing principle of English and American banking policy that dates back to the establishment of the Bank of England. I believe that principle is still valid today; banking is special and different from other businesses. The safety and soundness of the banking industry is enhanced by maintaining the separation of banking and commerce and banks free from affiliations with other firms are better able to serve as impartial judges of creditworthiness.

The nonbank firms do, of course, serve a function by adding to competition in banking markets. In less competitive markets, the consumer has another source of financial services. For example, Sears may be introducing national money market rates into some areas.

In expanding the powers of the banking industry, there is the danger that mergers between the major banks and the major insurance or brokerage firms would lead to an excessive concentration of the financial services sector. For example, if bank holding companies were permitted to own insurance underwriters, would we want Prudential and Citicorp to merge? Or, if bank holding companies were permitted full securities powers, would we want BankAmerica and Merrill Lynch to combine? While expanding bank powers, we want to prevent both the commingling of banking and commerce and high financial concentration.

The attempt by bank holding companies to expand interstate through nonbank banks is another situation in which statutory loopholes are threatening to reshape the financial system. While I favor the principle of interstate banking, it should not come about by default and I am hopeful that the Congress will act on this question soon.

While this form of interstate expansion is not desirable on general policy grounds, it would have the attractive competitive feature of requiring de novo entry into new markets. New entrants would have to compete for market share, rather than being able to buy the largest banks. Contrary to frequently expressed fears, de novo entry by large organizations does not harm the existing banks in a market. The size of its parent holding company does not appear to be a factor in the ability of a new subsidiary bank to acquire market share. In addition, de novo entry would minimize the impact of interstate banking on the nationwide concentration of deposits.

Finally, we come to the issue of regional interstate banking based on state action. Chairman Volcker expressed the Board's concerns over this route to interstate banking in his congressional testimony on September 13, 1983. At that time, he expressed the view that regional banking would be a new form of Balkanization of the banking industry. Inconsistencies are already developing as states select their regional partners. For example, the Georgia law would allow entry by Kentucky banks, but the Kentucky law only allows entry by banks in states immediately adjacent to Kentucky.

Second, the regional laws clearly discriminate against those states that are headquarters for the nation's largest banking organizations. None of the proposed regional zones would include New York. Utah's law allows reciprocal entry from Hawaii and all the Western states except California. Not surprisingly, the constitutionality of these laws is being challenged, and Board approvals of applications under the regional laws are being stayed pending court decisions. Constitutional issues include the need for congressional ratification of interstate compacts, the creation of new barriers to interstate commerce, and the issue of equal treatment under the law. Various bills in the Congress would attempt to remove the constitutional uncertainty surrounding these state laws, and ultimately the Congress and the courts will have to resolve these questions.

Two principles are involved in this conflict. First, we have the right of a state to determine its own banking structure, as provided by the McFadden Act and the Bank Holding Company Act. Second, there is the issue of the effect of one state's actions on the other states. Once a state exercises its option under the Bank Holding Company Act to allow entry by out-of-state firms, can it then discriminate among the states? Or, must allowing out-of-state entry be an all states or no states proposition? These are difficult questions and their resolution by the courts may produce landmark decisions on states' rights and the national interest.

In addition to the objections raised by Chairman Volcker, I have problems with the concepts underlying the rush to pass regional interstate banking laws. These laws are clearly designed to permit mergers among the largest banks within each region. Thus far, the bulk of the interstate activity has consisted of the acquisition of relatively large firms by even larger firms. Because the merging banks did not compete in the same geographic markets, the antitrust laws did not prevent their merger.

There has been no demonstration of any public benefits from regional interstate banking. The proponents claim that regional banking will lead to faster regional economic growth, but there is no evidence that there is any relationship between banking structure and economic development. They claim that the merging banks will achieve economies of scale, but there is no evidence to support that opinion. They claim that by growing larger they will be in a better position to survive the eventual entry of the nation's largest banks. However, there is no evidence that the regional banks need to be larger to survive. Survival is the result of providing good service at competitive prices and there is no evidence to suggest that this is directly related to the size of the organization. The advocates claim that larger banks can better serve the needs of large businesses, but there is no evidence that the credit needs of large business firms are not being met. In summary, there is no evidence to support the claims of the proponents of regional banking.

Regional bank mergers would have some negative impact on the aggregate concentration of banking resources in the nation. Many of the banks that would be involved in these mergers are among the largest banks in the country. In addition, if large regional organizations are formed now, and full interstate banking is allowed in a few years, the potential acquisition of the regional organizations by the national firms would lead to an even further concentration of banking resources.

Thus, while regional interstate banking does serve as a means of transition from state limitations on geographic expansion to full interstate banking, I think the transition period should be very short. The enactment of a national law with controls on large bank mergers would provide uniform expansion rules before intraregional large bank mergers set the stage for the increased concentration of banking resources.

To conclude my comments, let me again stress the important points. First, interstate banking is probably inevitable given the developments of the past few years. Second, while the arguments in its favor are not very strong, there is some potential for social gain. Third, the transition should take place on a level playing field under rules that do not disadvantage banks relative to their nonbank competitors. Fourth, the rules for interstate banking should be established by the Congress. Loopholes in the laws, such as those that allow nonbank banks, should not be the basis on which interstate banking develops. Finally, any system of interstate banking should contain effective constraints against mergers and acquisitions that would increase the concentration of banking resources and leave the nation's financial system dominated by a handful of giant nationwide banking organizations.