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THE TRANSITION TO INTERSTATE BANKING

Remarks by

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I thank you for inviting me to be with you for your annual convention. While I know that it is a subject of some controversy, I am going to speak on interstate banking. As you are aware, Chairman Volcker testified on this subject recently, and I would like to review with you some of the factors that went into the development of the Board's recommendations to the Congress.

The McFadden Act of 1927 has not been revised in any significant manner since 1933. State laws governing branch banking have evolved very slowly over the decades, and proposed changes have always been very controversial, as you well know. While there has been a recent trend toward liberalization at the state level, 24 states continue to prohibit statewide branching. There are still eight unit banking states, although five of those allow statewide expansion by multibank holding companies.

Prior to 1956, bank holding companies were permitted to own banks in any number of states, and several of these multistate bank holding companies are still operating. For example, First Interstate's subsidiary bank in New Mexico, is covered by the grandfather provisions of the Bank Holding Company Act of 1956. The Douglas Amendment, while barring general interstate expansion, gave the states the right to allow out of state entry, but the states have only recently begun to exercise this statutory option.

Even though the McFadden Act and the Douglas Amendment prohibit interstate banking, we have extensive interstate banking activity. The statutes simply force banks to conduct this interstate activity through a variety of alternative channels, some of which may be less efficient than full interstate banking. A 1983 study by the Federal Reserve Bank of

Atlanta found 7,840 offices of banking organizations that conducted some banking activity outside of the home state of the parent bank. Many other interstate activities are conducted by mail, by toll-free telephone numbers, and by personal visits. While some financial services have always been delivered outside of a brick and mortar branch office framework, the volume of these activities has increased substantially in recent years. The money market mutual funds, for example, have collected billions of dollars from across the nation without local offices. In one sense, then, allowing full interstate banking would be a recognition of the current level of activity.

Permitting full interstate banking, however, would be more than merely recognizing the current situation. It would lead to major additional changes with important implications for the development of the banking system. Prior to discussing some of the specific areas of concern to the Board, I will describe the factors that appear to be causing the pressures for changes in the law and the industry's responses to those pressures.

The Pressures for Change

There has always been some pressure for interstate banking. The very largest banking organizations have always been interested in expanding on a nationwide basis. Many of these banks supply some banking services — such as commercial loans — over a wide geographic area and desire the right to expand to the provision of full banking services. But, this is not a new pressure for change, and I will focus my remarks on pressures arising in recent years.

One new development causing pressure for change is the sharp increase in competition between banks and nonbank financial services providers. There are new players in the financial services industry. Although many of these firms do not have all of the advantages of banks — such as access to the discount window and federal deposit insurance — their expansion is not limited by state boundaries. Insurance companies, securities firms, and retailers can all operate offices nationwide. They can use their nationwide networks to market bank certificates of deposit, but a bank cannot establish its own interstate deposit-taking offices. Quite naturally, many members of the banking industry want to have the same nationwide geographic expansion rights as those they view as competing financial services providers.

A second factor behind the evolving pressure for interstate banking is the shift of the population within the nation. The population is moving toward the south and the west; the sunbelt states are growing relative to other areas. Banks in the northern and eastern states understandably want to be able to follow their customers to the rapid growth areas. Thus, there is a tremendous demand to be able to establish offices in states such as Florida; that one state accounted for 17 percent of the nonbank bank applications. Many consumers would probably like to continue their established relationship with their northern bank after they move to the south. While some customers may retain their old banking connections and bank by mail and automated teller machines, these alternatives are not perfect substitutes for full service branch offices. Therefore, many consumers moving to a new part of the country select a new bank and develop a new relationship.

The final force for change is what appears to be an acceptance of the inevitability of change. While we are all aware that there are still wide differences of opinion on the subject of interstate banking, there does appear to be less resistance to change than in the past. In the last few years we have witnessed the liberalization of state branching laws in a number of states, the adoption of multibank holding company laws in all but a few states, and the rapid spread of regional reciprocal interstate banking laws. Bank geographic expansion laws have changed more in the last five years than in any comparable period since the 1930s. Even in states that have rejected change in the past, new laws are being passed. For example, the Indiana legislature recently adopted an intrastate multibank holding company law after rejecting similar legislation annually for the past 17 years.

Perhaps the belief that change is inevitable has become the greatest force for change. Others see, as I do, that interstate expansion is taking place by various means. Thus, they conclude that interstate banking is coming and are positioning themselves for the new environment.

Industry Responses to the Forces of Change

The banking industry devised many methods to alleviate some of the constraints of interest rate regulations. Now, the pressures for changes in the interstate banking laws have brought forth similar industry responses.

The major vehicle for providing banking services on a multistate basis has been the nonbank subsidiary of the bank holding company. Because nonbank subsidiaries are not subject to the Douglas amendment, the bank holding company can expand interstate through this device. The Atlanta Reserve Bank's survey, which I referred to earlier, found 5,500 offices of nonbank subsidiaries of bank holding companies operating outside the parent holding company's home state. Most of these offices provide consumer finance and mortgage banking services; both of these activities could be conducted by bank subsidiaries of the holding company if interstate banking were permitted.

Technological advances provide a second means for banks to respond to the pressures for geographic expansion. By deploying automated teller machines, a bank can expand its geographic coverage for some functions other than deposit taking. Nationwide coverage can be obtained by membership in an ATM network. Through networks of ATMs, a bank's customers can access their accounts and perform some limited banking transactions from locations at which the bank would not be permitted to operate a full-service branch office. Although it is still in its very early stages of development, banking through home computers offers another technology based option for allowing customers to deal with banks outside of their home market.

Technology, however, also increases the pressures for change by reducing the difficulties of exercising central control over a network of banking offices. Funds can be transferred between offices, and lending and deposit performance can be monitored on a continuous basis.

Nonbank banks represented a third method of evading the full impact of the Douglas Amendment -- as well as being an attempt by nonbanking firms to enter banking. While a nonbank bank can, at some times, serve a purpose, the nonbank bank movement threatens both the laws against interstate banking and the traditional separation of banking and commerce. If these traditional restraints are to be changed, such changes should be the result of conscious decisions, and not the result of loopholes in the existing statutes. The substantial number of nonbank bank applications filed did, however, indicate the intensity of many banks' desires to enter new markets. While some were following their customers, most were seeking new customers in growing markets with high profit potential.

The regional interstate banking compacts are a final response to the pressures for change. Each month, additional states are enacting legislation permitting entry by bank holding companies headquartered in selected states. Because of the discriminatory nature of these laws, we do not think this is the best approach to interstate banking, except as a very short transitional system. The regional reciprocal banking laws may or may not be found to be contrary to the provisions of the constitution, but the Supreme Court's ruling will probably not turn on the economic merits of the regional banking concept.

In sum, there are pressures for interstate banking from various sources, and the banking industry has developed a variety of means -- most of which fall short of full interstate deposit taking -- for providing banking services across state lines. The time has come to determine if allowing full interstate banking operations would be in the public interest.

The Board's Concerns with Interstate Banking

In discussing interstate banking as an economic concept, it is difficult to argue that an industry should be forced to confine its operations to a single market or a single state. Indeed, we rely on free entry into markets as the competitive force causing existing firms in the market to produce the best quality product at the lowest possible cost. Any restrictions on entry involve some loss of competitive vigor, and should be justified by some overriding alternative objective. We have examined many factors that might constitute justifications for prohibiting interstate banking, and I would like to discuss several of these topics.

Safety and Soundness

Perhaps above all other issues, the Board is concerned about the future safety and soundness of the banking system. We don't want to set the stage for the development of a system that will be failure prone.

According to the historical data, there is no systematic relationship between bank failures and state branching laws. While branching doesn't prevent failures, it doesn't cause them either. Most bank failures can be attributed to fairly clear causes — bad management, inadequate capital, criminal activity, or poor lending practices. No bank failure has ever been demonstrated to have resulted from the structure of the market's banking industry, although restrictions on branching and bank holding company expansion do limit the options available to the regulators in dealing with a bank failure.

Some have argued that the problems of Continental Illinois were attributable to Illinois' laws prohibiting branch banking. According to this argument, the bank relied on purchased money because it could not operate a branch network to obtain more stable consumer and business deposits. I would not subscribe fully to this view because many other factors contributed to the failure. However, the bank's ability to attract core deposits was certainly very limited by the Illinois laws; avoiding the use of purchased money would have required a very substantial contraction of assets.

There are, however, some safety and soundness issues that do cause us concern, although I would also point out that there may be some risk reduction resulting from the geographic diversification of both loans and deposit sources. Our first concern is that some major institutions -- in their rush to expand geographically -- might pay excessive prices to acquire banks, and in the process, reduce their capital ratios to unacceptable levels. Carried to the extreme, acquisition debt could tend to increase, as could intangible assets. However, pressures from the market and the regulators should limit this risk, as long as both the market and the regulators are concerned about capital standards.

A second risk -- one that is much more difficult to anticipate -- is the risk of the failure of a giant nationwide banking organization. Would interstate banking result in the formation of banks that would be too large to be permitted to fail? Certainly, over time, the largest banks would be much larger -- on a relative basis -- than the largest banks today. There would be few potential acquirors of a failed giant nationwide firm.

Finally, the institution of interstate banking would reduce one of the incentives for banks to acquire failing organizations. Currently, the ability to enter an otherwise prohibited market is often the motivation for a bank to acquire a failing institution. If entry were allowed by the acquisition of a healthy firm or the establishment of a new bank, would banks be willing to acquire a failing organization? Most likely, their incentives would be reduced and the FDIC's cost of resolving failures would be increased.

Competition and Aggregate Concentration

Our second concern is the potential impact of interstate expansion on competition and the concentration of banking in the United States. We believe that the maintenance of a competitive and unconcentrated banking system should be given high priority in the design of an interstate banking plan.

Beginning with competition in local banking markets, we do not think that interstate banking would create substantial problems. New firms entering a market by acquisition would merely replace the acquired firm without changing concentration. Entry by the formation of a new bank would lead to some market deconcentration as the new firm gained market share.

Research suggests that local banking market concentration is decreasing over time. This conclusion holds both for markets in high concentration states with statewide branching and markets in low concentration states with unit banking. The antitrust laws, by barring anticompetitive mergers between firms in the same geographic markets, have also prevented concentration problems within markets. In addition, the growing number of out-of-market competitors, such as the nonbank financial firms and the money market mutual funds, reduces the ability of firms in the market to exploit their market power.

The issue of the aggregate concentration of banking resources is more troublesome. The present barriers to interstate banking have prevented a high level of national banking concentration. The top 100 banking organizations now control only 53 percent of total domestic banking assets. However, I would expect rising nationwide concentration as a result of interstate banking, especially if we do not prevent large bank mergers. The significance of rising concentration in banking, however, depends in part on the degree of effective competition provided to banks by other financial services firms. If securities and insurance firms are able to provide all banking services, the threat of banking concentration is less than if barriers prevent these firms from competing with banks.

There are a number of justifications for the traditional American desire to avoid aggregate concentration in banking. The nation has attempted to maintain a deconcentrated banking industry in order to avoid adverse economic and political effects thought to stem from financial concentration. The banking system is maintained as a nationally competitive industry offering potential borrowers a wide variety of potential sources of credit, and distributing the power to allocate credit among many firms.

The existing antitrust laws are not likely to prevent the large bank mergers that would produce higher levels of nationwide concentration. The merger of two giant firms from different states would not eliminate any existing competition because the merging banks would not have been competitors in any of the same local banking markets. However, while no existing competition would be eliminated by the merger, the level of aggregate concentration in the nation would be increased. The current antitrust laws have not been successfully applied to these market extension mergers, regardless of the size of the merging banks.

Given the considerable uncertainty about the ability of the antitrust laws to control large bank mergers, some statutory merger restrictions need to be included in an interstate banking law. There is no perfect formula for determining which mergers should be prohibited and which permitted, but the rule should prevent mergers among the very largest organizations and prohibit those firms from acquiring the large regional banking firms.

Although we regret suggesting new controls on bank expansion, if we failed to prohibit mergers amongst the largest banks, I fear that a large percentage of total banking assets would soon be held by a very small number of banks. There would still be thousands of banks in the country, as well as many nonbank financial service providers, but the bulk of the nation's total banking assets would be held by relatively few institutions. The details of the merger restriction plan required are still uncertain, but for the sake of the long-run structure of the industry, we believe very strongly that some large bank merger limitations should be included in any interstate banking legislation.

Regional Interstate Banking

As the Board has indicated on numerous occasions, we do not believe that regional interstate banking compacts are the appropriate way to move toward interstate banking. The pending Supreme Court case will decide the constitutional issues involved in regional compacts. Therefore, I will confine my comments to the economic issues.

While the widespread adoption of regional interstate banking would lead to the Balkanization of the banking industry, we cannot find any substantial offsetting economic merits to this approach, other than the fact that they begin the breaking down of the state barriers to expansion. The proponents argue that mergers between the large banks within a region would yield economies of scale. While there may indeed be such economies, formal academic studies have not found systematic evidence to support their existence. Likewise, there is no evidence that regional banking will promote a region's economic development.

Many of the regional banks argue that, by merging with other regional banks, they will be better prepared for the eventual entry of the money center banks. The process of preparation, however, is unclear. There is no evidence that they cannot compete with the money center banks now. Too frequently, their arguments sound like a justification for mergers that will make them more attractive for eventual acquisition -- at high merger premiums -- by the money center banks. This is certainly contrary to what we would hope to have develop. Many of the regional banks are very strong and certainly can survive on their own. I would prefer to see the regional banks expand by acquiring smaller firms in other states and forming new multistate organizations. Their expansion should not be based on mergers with other equally large organizations within their own region.

Avoidance of regional barriers would most likely result in a more geographically diversified pattern of entry into a state. Maine serves as an example of this objective. The Maine statute allows entry from any state. The expectation was, of course, that entry would occur from Boston and New York City. Two of the first entrants into Maine, however, were based in Albany, New York. If Maine had passed a New England regional law, there would have been only two new entrants thus far, and there would have been far fewer options available to those Maine bank holding companies seeking to be acquired.

I think that a period of regional banking compacts would lead to significant regional banking consolidation. Then, when full interstate banking was permitted, the acquisition of those regional banks by the money center banks would result in an even higher level of national concentration. We believe that it would be better to begin with nationwide banking and adopt merger controls before concentration can increase on the regional or national level.

Small Banks and Community Credit Needs

The possibility of creating large nationwide banks invariably brings up the issue of whether small banks would be able to survive in competition with these giant institutions. We do not, however, view this as a major problem. Federal Reserve staff studies, as well as those conducted by members of the academic community, indicate that small banks can survive in competition with large branch banks. The empirical evidence indicates that economies of scale in banking are sufficiently limited to permit the profitable operation of banks of widely varying sizes. There are many very profitable small banks in metropolitan markets containing the nation's largest banks. Each year many new banks are organized in California in spite of the fact that California's statewide branching banks hold large market shares in each of the state's metropolitan markets.

The changing technology of the banking industry, rather than acting to the disadvantage of the smaller banks, is helping those banks. Indeed, if the banking industry is becoming more electronic based, rather than being based on branch networks, the small single office bank may have a cost advantage over its large competitors. The small bank can gain access to shared nationwide ATM networks and can purchase services from an expanding number of vendors, even if it cannot produce those services itself.

There is also some fear that a large bank would enter new markets, especially small rural areas, and drain funds from those markets to support its national and international lending programs. These fears are without empirical justification. Consumers expect that the bank that takes their deposits will also meet their loan requests. If a bank does not meet loan demands in the market, its customers will move their funds to banks that are willing to lend. Thus, failure to lend is a formula for deposit loss. Especially under a system of free entry, such as would be the case with interstate banking, other banks will be searching out markets with unmet credit demands. They will enter those markets and take deposits away from any bank that is merely using its market presence to raise funds for lending elsewhere.

Dual Banking System Issues

The United States has a unique banking system, in part because of the traditional division of chartering and supervisory powers between the national banking agencies and the state banking supervisors. This dual banking system fits with the concepts of federalism embodied in our constitutional system of government. We should retain this dual system of chartering and regulation in the process of moving to interstate banking. On a very practical basis, the dual banking system would be served best by a system of multistate bank holding companies, rather than a system of interstate branch banking. A nationwide branch banking system would be difficult for any one state bank supervisor to examine and regulate. There could be conflicts between the laws of the organization's home state and the laws of other states in which branches were located. A nationwide bank, rather than being subject to many state bank regulators, would probably opt for a national bank charter. Thus, under interstate branch banking, most multistate banks would be national banks. With interstate bank holding companies, however, the parent organization would have separately chartered bank subsidiaries in each state. Those subsidiaries could have either national or state charters, and would be examined like any other bank.

By allowing interstate bank holding companies, rather than interstate branching, states would still be permitted to control certain aspects of their banking structure. For example, branching within states could still be controlled by the states, even if interstate bank holding companies were permitted. In addition, states could prohibit multibank holding companies within the state; under that prohibition, a multistate bank holding company could acquire only one bank in that state. Likewise, states could still limit the percentage of state banking assets controlled by any one firm, as several already do.

The multibank holding company approach to interstate banking has been tested and appears to be working. No supervisory problems have been reported as a result of the operations of the grandfathered multistate bank holding companies. Also, there has been no tendency for these holding companies to place all of their subsidiaries under one regulator. These multistate multibank organizations are, for the most part, mixtures of state and national banks. For example, First Interstate, the largest of the multistate organizations, owns 15 national banks and eight state banks; of its total deposits, 50.3 percent are held by national banks and 49.7 percent by state banks. Examining the range of chartering practices of seven multistate bank holding companies, we find one organization with 91.2 percent of its deposits in national bank subsidiaries and one organization with 89.0 percent of its deposits in state bank subsidiaries. Thus, it appears that the existence of multistate bank holding companies has not been disadvantageous to the dual banking system.

The Board's Interstate Banking Proposal

Having discussed some of the policy issues that were of concern to the Board, let me conclude by outlining the provisions of the Board's plan for a transition to interstate banking.

As I indicated earlier, the Board prefers to see nationwide interstate banking, rather than regional agreements. Because the regional plans have become popular, however, our plan would permit them as a transitional system. Under the recommendations that we made to Congress, any state that entered a regional reciprocal interstate banking group would be required, after three years, to permit entry by banks headquartered in any state that provided reciprocal entry rights. Note that this plan would permit a state to opt out of interstate banking entirely. By not enacting a reciprocal law, it would not have to allow entry from any other state. However, once it permitted entry from any one state, eventually it would have to allow entry from all states permitting its banks equal entry rights.

This plan permits the states to retain control of their banking structure, other than by limiting their ability to discriminate among the other states. I think that this system provides a good balance between the preservation of states' rights and the elimination of differential treatment.

The proposal also includes controls on the aggregate concentration of deposits. Mergers among the largest 25 banking organizations would be prohibited, and there would be limitations on the national share of assets that could be acquired through acquisitions. An exception to these rules would be made for failing banks; this would be a strengthening of current federal statutes.

Another feature of the Board's Congressional recommendations would permit interstate expansion within metropolitan areas composed of parts of two or more states and within neighboring areas of contiguous states. This relatively modest change would reduce the inconvenience that many consumers experience in areas such as the Washington metropolitan area, which is comprised of parts of three jurisdictions.

To conclude my remarks, I would make three final points. First, the process of banking deregulation is continuing and a reduction of the barriers to interstate banking will be part of that process. Second, while the Board has made some relatively specific recommendations to the Congress, other proposals will also be considered. Therefore, the ultimate outcome in the Congress is very unclear at this point. Finally, while there is proposed legislation in the Congress and the odds for change are higher than in the past, one must not discount the lingering opposition to change. One should not assume that something must happen in this legislative session. We are moving in the right direction, but the goal may still be some years away.