

## **Interstate Banking, Competition and the Health of the Industry**

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In recent debates on reciprocal interstate banking laws in Georgia and her sister states in the Southeast, there has been plenty of disagreement about the effects of interstate banking on both banks and the public interest. This evening, I would like to talk about two important aspects of the public interest: competition and bank safety. Let me start by speaking about interstate banking generically, assuming that no regional, reciprocal, new bank or branch limits apply. I will conclude with a few words about the special cases of regional interstate banking and new bank limits, both of which appear in Georgia's new banking law.

### **Interstate Banking Currently Exists**

The first point that I want to make about interstate banking is that it is quite prevalent in many places. Let's look at Georgia. The state has more than 250 offices of out-of-state bank holding companies offering almost all bank services except on-site deposit taking offices. In addition, at least nine loan production offices of large out-of-state banks operate in Atlanta. You may have seen full page advertisements for the newest of these offices. (The ads ask "What is Chase Manhattan doing in Georgia?" and answer "Giving you the credit you deserve.")

Edge Act corporations and offices of foreign banks with multistate operations account for 15 more out-of-state bank offices. Two of the nation's largest thrift institutions operate in Georgia with offices that offer many banking services. All told, more than 275 offices of out-of-state banks, bank holding companies and thrifts institutions operate in Georgia.

Interstate banking is prevalent in the states surrounding Georgia also. In a count that we did about a year and a half ago, we found 108 offices of out-of-state banks

in Alabama, 505 in Florida, 370 in North Carolina, 229 in South Carolina and 202 in Tennessee.

There is nothing in the cards that seems likely to wipe out existing interstate banking. Indeed, there seem to be new breaches of the barriers separating the states almost everyday. Soon U. S. Trust Corp. of New York will convert its Miami trust office into an FDIC-insured bank which will take all kinds of deposits and make consumer loans. This is but the beginning of a new, and significant phase in the advance of interstate banking. At least 12 large bank holding companies have applied for more than 100 interstate banking offices under the ruling that permits U.S. Trust to operate in Miami. This phase, I should point out, is being carried out under the Bank Holding Company Act with the grudging approval of the Federal Reserve Board.

In part because of the market forces generated by existing interstate banking, several states have already taken it upon themselves to pass interstate banking laws before the federal government decides what is to be done on a national scale. So far 17 states have some sort of limited interstate laws. They range from those of Maine and Alaska, which allow unlimited holding company acquisitions, to those of Florida and Iowa which allow specific "grandfathered" companies to make acquisitions in their states.

Four states have now enacted regional, reciprocal banking laws. The Board of Governors of the Federal Reserve System eliminated much of the uncertainty about whether it would allow bank holding companies to take advantage of these regional interstate banking laws in late March by approving two interstate acquisitions under such laws in New England.

Georgia is the latest of the states with regional reciprocal laws. Its recently enacted statute allows bank holding companies from any of nine other southeastern states which passes a similar law to acquire Georgia banks. The act becomes effective in 1985.

The inroads of interstate banking imply two things: First, those who fear interstate banking because they fear competition with out-of-state banks are already competing with them in many markets. Second, many of the projected benefits of interstate banking may already have been achieved and many of the projected costs already have been incurred. Some part of the transition from strict geographic control to full interstate banking has already taken place. Further changes are not likely to be as important as if all the doors had opened at once.

Still, further moves to change geographic restrictions should be made with an eye on public benefits and costs of those moves. I would like to turn now to the two major types of public benefits and costs: competition and safety.

#### **The Probable Benefits of Interstate Banking Exceed the Probable Costs.**

Most of the debate about interstate banking assumes (correctly, I think) that larger banks will cross state lines with acquisitions and that unacquired smaller banks and bank holding companies will have to compete with larger banks than they do now. Consequently, most of the evidence on benefits and costs of interstate banking comes from studies of differences between large and small banks.

#### **Competition.**

What do we know about competition between large and small banks?

1. A large body of research on costs of producing basic banking services—DDA, savings and time accounts, consumer and commercial loans and investments—has concluded that larger banks have no production cost advantages over small ones. The evidence indicates that banks of \$50 million to \$100 million in asset size produce basic banking services most efficiently. Banks smaller than these may have substantial cost disadvantages; larger banks' cost disadvantages are slight.

2. Other studies of larger banks' performance when they enter new markets strongly suggest that they do not seriously harm smaller banks or take away their

market share. This has held true whether the larger banks entered with new operations or acquired foothold banks or acquired dominant banks.

New York City banks have had a very difficult time gaining market share in upstate New York since they entered markets there in the early 1970s. By 1980 their average market share gain in metropolitan areas was 1.3 percentage points. Spot checks of 1982 branch data indicate that they are still making few, if any, gains.

In California more than 150 new banks were started during the 1970s. More than 140 are still operating in competition with some of the largest branching systems in the nation. Banks started in the early 1970s have grown close to the \$100 million asset mark on average.

Large bank holding companies in the Southeast have had no better records. Their de novo banks have done no better than independent de novo banks in the same markets. When they have acquired banks with large market shares, they typically have lost share in the aftermath.

3. Future introduction of computer techniques with substantial economies of large scale are not likely harm small banks' competitive position against large banks. There will be numerous service companies, franchisers, correspondents and cooperatives willing and able to run large service operations and sell services to small banks. Small banks may even have an advantage in this because they can avoid major capital investments. That will allow them the flexibility to adopt new techniques as they appear.

4. Most of our country's largest banks have capital-asset ratios which are close to their regulatory minimum. If banking regulators make these banks toe the line on capital, most money center banks will have limited capacity for interstate expansion with current capital. To expand they would have to go to the market for capital. I have serious doubts whether the markets could digest a lot of large bank equity or long term debt in a short time, particularly with competition from the large Federal deficit and capital requirements of a maturing economic recovery.

5. Large banks are able to offer some sophisticated services that small ones cannot offer competitively. Entry of larger banks will add convenience and flexibility for some customers which use those sophisticated services. Small banks' losses from this are not likely to be great because the customers in question are not usually their customers.

These facts suggest that interstate banking does not pose a threat to smaller independent banks and bank holding companies. Nor does it seriously threaten to raise local market concentration. Smaller banks are likely to survive if they decide to and if their managers are sharp and they plan ahead. Second-tier holding companies appear likely to be able to do the same. They will have to manage new changes as most have successfully managed the change from controlled deposit rates to market determined deposit rates, but the evidence from academic studies of costs and from market experience indicates that they can.

For these reasons, we are not greatly concerned that local market competition will be harmed by interstate banking. If anything, the evidence suggests competition will be enhanced. More competitors will enter some markets where profit opportunities are greatest. In all markets, bankers will have to be more wary of new competitors "waiting in the wings" for a local bank to make a mistake. This should improve the quality and decrease the prices of financial services. The Federal Reserve will, of course, continue to analyze competitive effects of acquisitions and to deny acquisitions that have seriously adverse effects, but we are not particularly concerned that interstate banking will make this job more difficult.

We are not greatly concerned about concentration of aggregate power either. The cost studies and market experience that I spoke of earlier indicate that banking is not what economists call a "natural monopoly" industry. The largest producers do not appear to be able to get their products to the customer at a lower price than the smaller ones can. This leaves openings for smaller producers to compete effectively

and to discipline larger producers to offer quality services at competitive prices. As I indicated before, I think there is room for many banks even in a full interstate banking system.

Certainly some banks will accept offers that they cannot refuse from out-of-state acquirers. We will have fewer banks than the 12,000 or so independent banking organizations that we have now. Aggregate concentration will increase but there is no reason to believe that the increase will be sufficient to cause a threat to the public. More than enough banks will remain to discipline any bank that tries to exploit a concentrated position.

**Safety.**

The comments made above should tell you that we do not expect to see interstate banking causing an epidemic of trouble among small banks. Previous changes from unit banking or local branching to statewide holding companies or branching do not seem to have had that effect, even in New York.

Change, of course, invites mistakes and we expect to have to deal with some banks that have made mistakes. But most bank managers have been forced to learn to handle change already. We do not expect interstate banking to cause their banks to drop like flies.

There are three other "safety and soundness" effects that interstate banking may have, however. Two of these decrease our concerns about safety but one does give us some problems. First the good news. Opening up state lines will make it easier for regulators to find merger partners for failing banks. Congress saw this when it passed the emergency provisions of the Garn-St Germain Act. That law allows large bank and thrift acquisitions across state lines under limited emergency conditions. Interstate banking would simply take the principle further.

In addition, if larger banks are able to acquire deposits from a broader geographic area, they may be able to shift sourcing of some deposits from the money markets to

a more stable base of individuals and corporations. The money markets occasionally act as a herd; thus, a broader deposit base for large banks will ease our minds about events that might make the markets nervous enough to start a run against a large bank.

On the other side of the safety coin, greater concentration of deposits in large banks would make some banks bigger and harder to handle in the event they get into trouble. It might also increase the geographic spread of the problems caused for their customers. Consequently, regulatory and insuring agencies would be under more pressure than we already are to shore up the large banks and, implicitly, to give them more incentive to take risks.

This last concern worries me less than it does some because I see less danger, in practice, that concentration will increase significantly and because large banks are likely to gain broader deposit bases and greater asset diversification by going interstate.

Our concerns about interstate banking's adverse implications for competition and safety are not great. There are certainly net benefits for the public in interstate banking's effects on competition. Safety implications may be slightly positive. No epidemic of problem banks is likely, and we are ready to handle isolated cases in which banks have adjustment problems.

#### **Limitations on Interstate Banking are Matters for Concern.**

I do have two other concerns about the way states are going about interstate banking right now that I would like to get on the table here. Most of the benefits of interstate banking arise from the gains in competition that come from larger numbers of competitors and potential entrants into banking markets. Laws that limit entry limit these gains. Both regional compacts and laws that allow acquisitions only of banks that have operated for a certain number of years limit entry. Of the states with reciprocal interstate banking laws, Georgia alone explicitly requires acquisition of an existing bank, Massachusetts and New York explicitly allow de novo acquisitions and Connecticut and Rhode Island have no explicit provisions on the subject. The two

states that allow interstate banking without reciprocal requirements are split on acquisition of new banks; Maine allows new entry but Alaska does not.

We are not absolutely certain that undue concentration and safety problems will not develop, thus, a regional strategy may be useful as a transitional device. It may also be a necessary political strategy. However, a permanent regional policy would permanently limit competitive gains. In addition, it would limit the number of bidders able to deal with bank owners who choose to be acquired rather than to continue.

Limitations on new entry ultimately have little or no value to the public. They directly block new competition—the major reason for expecting benefits from interstate banking. They exclusively enhance the wealth of bank owners. Though that may be considered a plus by members of this audience, I do not believe that new entry limits are good public policy in the long run.

Having worked for a bank regulator for much of my career, I am used to being concerned about the impact of changes of all sorts on banks and the banking system. For me, interstate banking does not raise serious concerns about loss of competition, about development of high concentration in the economy, or about bank safety. We at the Federal Reserve are aware of the possible dangers to competition and bank safety and will monitor them closely. My strong feeling, however, is that interstate banking's main impact will be increased competition. That will be to the public's benefit.