Interstate Banking and the Economy

mostly a review of pending legis. + judicial decisions in interstate banking

Remarks of Robert P. Forrestal
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to the National Association of Accountants
Atlanta, Georgia, February 18, 1985

It is a pleasure to meet with you today. I have always felt a sort of kinship with accountants, since you share a good many interests with bankers and our paths cross rather frequently. You have asked me to address two topics — current developments in interstate banking and the economic outlook. Let's begin with interstate banking, an area that has been seething with activity of late.

Interstate banking has been a topic of keen interest at the Atlanta Fed since late 1982, when we surveyed the industry and found that a number of the nation's larger banks already operated hundreds of offices of one sort or another from coast to coast. Some had come into existence through the "nonbank bank" loophole. Some were holding company subsidiaries established under Section 4(c)8 of the Bank Holding Company Act. Market forces were triggering these operations. Even foreign banks were involved; Barclays Bank, for example, was among those with hundreds of consumer finance and leasing company offices nationwide. And nondepository firms, too, were edging into bankers' turf. Firms like Merrill Lynch, American Express, and even Sears, Roebuck and J.C. Penney were beginning to make their presence felt.

It was in 1982, then, that we began to speak of interstate banking as an accomplished fact. Just last fall, we sponsored a conference on "Interstate Banking: Strategies for a New Era," and invited a number of uniquely qualified authorities to examine various aspects of the phenomenon.

In accordance with our usual practice, we are sharing the results of that conference in the form of two special issues of our Economic Review. The first of these two issues was published in January. I have brought along a supply for those of you who want to delve into it more deeply. That issue is devoted to various business strategies — including mergers and acquisitions — that large and small banks may find useful in the new environment. A second issue of the Review, due out in about three weeks, will deal with the public policy questions raised by interstate banking. If that aspect of interstate banking is also of interest to you, you'll find instructions on how to request the March Review inside the cover of the January issue.

Some of the major conclusions arising from that conference had to do with factors that will be keys to success in a future environment characterized by still more interstate banking. One major conclusion was that bank size is unlikely to be important. Two of the more solidly researched conclusions are, first, that above $75 million or so in asset size, banks do not appear to gain economies of scale in producing basic banking services. The second is that over the past 15 years, when large banks have entered markets in competition with smaller banks, the larger banks have failed to penetrate the market significantly.

There seems to be a place for both large and small banks in our financial system. Small banks provide both continuity and sophistication of service for customers too small to have their own financial specialists. They must be close to the customer to succeed. Large banks, on the other hand, serve large multi-office or even multinational customers. They are, in many cases, providing transactions services on a huge scale for customers who employ their own highly specialized financial experts.

The absence of size advantages emphasizes the fact that it is the quality of management that really determines the future of a given bank. Both large and small banks can survive. However, unless the costs of obtaining funds and providing services are strictly controlled, the quality of service is carefully maintained, and technological and structural change is managed creatively, success may be elusive.

Edward Furash, a Washington-based financial consultant and one of the speakers at our conference, noted that interstate banking actually had little affect on those requirements. With or without interstate banking, the basic challenge to bank management remains essentially the same.

But our future environment will include a great deal of interstate banking. It is very real, and its impact will be widespread. Legal and communications innovations are allowing market forces to break more geographic barriers almost every day. Let me review some of those recent events for you.

It is interesting that one of the first items of note on the recent interstate banking scene involves not a bank, and not even a primarily financial firm, but Sears, Roebuck. Just before the end of last year, we learned that Connecticut Banking Commisioner Brian Woolf had ordered Sears to stop taking deposits at two Sears Financial Centers in Waterford and West Hartford. According to Woolf's order, Sears must stop offering a "sweep account" in which their Dean Witter brokerage service sweeps funds into Sears Savings, the firm's savings and loan association. But this may be no more than a delaying action. Under Connecticut law, if the banking commissioner deems a holding company to be in the banking business, it can establish no more than two nondepository offices in that state per year. Sears has responded with a lawsuit challenging the constitutionality of the Connecticut law restricting activities of bank and savings and loan holding companies. The outcome obviously could have important implications for both interstate and interindustry competition for banks.

Just a couple of days after that bit of news broke, we heard that U.S. National Bank of Oregon, the state's largest commercial bank, had broken ranks with Oregon's banking industry over a plan calling for regional interstate banking beginning in 1986. The Oregon Bankers Association had agreed to a plan that would allow most banks in the state to be purchased by banks in eight other western states. U.S. National Bank, which supports interstate banking, objects to two key aspects of that plan; it objects to its lack of a reciprocity requirement, and it objects to a provision that would allow endangered Oregon banks to be acquired earlier than other institutions. Oregon's legislature began its 1985 session this month; it will be interesting to see whether the lawmakers pass some sort of regional interstate bill and, if so, what shape it will take.

The new year was only about a week old when one of the most significant news items reached us. The U.S. Supreme Court agreed to determine the constitutionality of state banking laws that limit interstate mergers to certain other states. The case before the Supreme Court was filed by Citicorp and New England Bancorp of New Haven, Connecticut. They are challenging Federal Reserve Board approvals of mergers under state laws that limit such mergers to states participating in the New England regional interstate compact. That is of particular interest to us here in the Southeast, of course. I'm sure that legislators in Oregon and many other states also will have that pending decision in mind as they debate the formation of similar regional interstate pacts. When it comes, the ruling will have a crucial impact on the strategies of many bankers.

It is difficult to predict when that ruling may be forthcoming; the Supreme Court agreed to hear the case only quite recently, and it seems unlikely to depart from its usual deliberate course in arriving at a decision. The oral arguments probably can't be heard until next month at the earliest. If they are not heard by April, the case may not be decided before the Court's current term ends around midyear. In that event, the case could not be decided until the court's next term begins in October. Such a delay would make it difficult to sustain several interstate deals struck in New England. However, it would not necessarily slow the development of interstate deposit-taking. Nonbank banks, interstate deposit brokerage, and other developments will continue to spread.

In a related move that created headlines on January 23, Citicorp filed suit in the U.S. Court of Appeals for the Second District in New York to block the SunTrust merger. That merger between banks in Georgia and Florida was the first approved by the Federal Reserve Board under state laws that created the Southeast's regional interstate banking compact. At that time, an attorney for Citicorp reportedly said that negotiations were underway that could suspend that lawsuit until the Supreme Court decides the New England case.

Among the significant recent developments that promise interstate deposit-taking without regional compacts is the Federal Reserve Board's proposal to allow BHCs to provide certain administrative and back-office services to their nonbank bank subsidiaries. This proposal could give new legitimacy and efficiency to out-of-state nonbank banks. Services like data processing and bookkeeping would be included, and the holding company and its nonbank subsidiaries could also share officers and directors. In addition, the proposal would preserve any trust service agreements between trust companies and subsidiaries converted into nonbank banks. This is just a proposal now, but it does reflect the concern of the majority of the Board of Governors for the efficiency of banks' operations.

About two weeks ago, the Federal Reserve Board granted approval for Chase Manhattan Corp. to establish limited-service banks — another expression meaning nonbank banks — in five states. Chase promptly announced plans to open such banks in three of those states — Arizona, California, and Minnesota — next month. Chase expects to go into the other two states — Illinois and Ohio — in April.

This latest flurry of action on the nonbank front obviously puts further pressure on Congress to address the interstate banking issue. The chairmen of both the House and Senate banking committees have threatened to press for legislation that would close down any such nonbank banks, so a showdown appears to be shaping up.

The nonbank issue is heating up elsewhere. Recently, the Federal Reserve Board asked the Supreme Court to hear an appeal of an important lower court ruling on permissible activities of nonbank banks. That lower court had overturned an earlier Fed ruling that would have expanded the definition of banks under the Bank Holding Company Act. What we call the "nonbank bank loophole" opened up because that act defines a bank as an institution that accepts deposits and makes commercial loans. To get around that, corporations began to create subsidiaries that performed one of those functions, but not both; hence the term "nonbank bank." The Fed was trying to tighten up this loophole by expanding the definition of "commercial loan" in the Bank Holding

Company Act. In that category we would include interbank loans, purchases of CDs, sales of federal funds, and several other activities.

If the Fed's regulatory power to redefine the term "commercial loan" is upheld, the impact would slow the future evolution of interstate banking through nonbank banks. I won't try to predict just what the new definition might be. But I would point out that, once the water is over the dam — that is, once nonbank banks have been established — it would be extremely difficult if not impossible to pump it all back to the high side.

A lengthy story in the February 8 edition of American Banker reported that, at an informal meeting in Washington two days earlier, Fed attorneys had sought guidance and testimony on the validity of state laws that prohibit nonbank banks. That story speculated that the Fed was likely to deny "a boatload of applications" filed by out-of-state bank holding companies seeking to set up nonbank banks in Florida — one of the most tempting markets in the nation, of course. Some of those attending that meeting also suggested that the decision, expected early in March, would contain some sort of statement expressing serious doubts about the constitutionality of state laws prohibiting nonbank banks. That will be another interesting decision to watch for, although it may be delayed while the Board evaluates the information gathered at that informal meeting.

Another important decision that was scheduled to be made before the end of February may also be delayed. The Federal Reserve Board was scheduled to rule on an application by Citicorp to acquire a North Carolina industrial bank. However, the Fed may choose not to act on that until a Citicorp lawsuit against the North Carolina banking commissioner is resolved. The commissioner denied Citicorp's application last year.

After a lengthy period of legal wrangling, and after it became apparent that Congress was not likely to deal with the issue anytime soon, the Comptroller of the Currency last fall approved a number of long-pending applications for nonbank bank charters. Since the dam broke, the Comptroller — who is the primary regulator of national banks — has approved 167 of these applications. Another large batch was scheduled for approval last Friday. The Federal Reserve Board has approved the acquisition of only about a dozen nonbank banks by bank holding companies so far, but the situation is changing rapidly.

All this activity is evidence that the market forces behind interstate banking remain strong. Many participants in the financial markets see profits to be made in interstate deposit-taking and lending. A setback or two in a regulatory or legal case will not dissipate those market forces.

It is highly significant that the American Bankers Association finally reversed its long-standing opposition to interstate banking just about a week ago. The ABA has now proposed a plan that accepts the closing of the nonbank bank loophole in return for laws permitting new banking powers and formalized interstate banking. That certainly doesn't end the controversey, but it is further evidence that the idea is gaining acceptability.

And that's where we are at this point. Where will we be in 1995? It seems likely that interstate banking will continue to spread. There probably will be a good many mergers and acquisitions within regional groupings of states — and possibly nationwide, if the last geographic barriers are blown away by Congressional action. There will be fewer banks by 1995, but there will still be both large and small banks to meet the varying needs of our diverse economy.

Now, let's turn from interstate banking to the economic outlook, a subject of interest to bankers and accountants alike. I think you'll find the outlook quite pleasant, for the most part. There are some unusual opportunities available to us, and I'll share with you my thoughts about how we as a nation can take advantage of them. But there are also some hazards to be wary of — hazards that might possibly put the opportunities out of reach. I think we know how to avoid those hazards, but steeling our national will to the task may present a problem.

The National Outlook

A year ago, many economists had serious doubts about the recovery's strength and durability. Most were predicting rather modest GNP growth, and many thought inflation would be higher than in 1983. On the brighter side, some forecast a decline in the exchange rate of the dollar and thus some improvement in our nation's international trade situation. My views were generally similar. At that time, I projected that the economy was likely to slow to a growth rate of around 5 percent and that unemployment would probably hover around 8 percent, perhaps dropping to 7.5 percent by the end of 1984. In addition, I expected inflation to pick up to about 5 percent.

Although these projections were not far off the mark, it was my happy experience to have erred on the side of underestimating the enormous growth in GNP while overestimating both the inflation and unemployment that actually occurred in 1984. As you all know, 1984 brought heady economic growth in the first half. GNP expanded at a rate far in excess of what had been anticipated, and the full-year growth rate was nearly 7 percent, the highest in over 30 years. This expansion was led by consumers; their purchases of homes, cars, appliances, and a myriad of durable and nondurable items spurred businesses to increase production, expand their work forces, and build their inventories in anticipation of continued strong sales. Businesses also served as a dynamo of growth by sharply increasing their spending on capital goods. Business investment, particularly in machinery and other equipment and, to a lesser extent, in new plants, contributed significantly to the expansion we witnessed in manufacturing as well as construction.

A sharp slowdown took place in the third quarter, reducing GNP growth in that quarter to less than 2 percent and raising concerns in some quarters that our expansion might not last much longer. Consumer spending, including auto sales, cooled substantially. Construction of single-family homes had slowed earlier in the year in response to upward movements in interest rates. The third-quarter moderation in consumer spending caught many producers and retailers off guard. Coupled with the previous weakening in construction, the reduction in consumer spending left many manufacturers and merchants with large inventories accumulated earlier in the year. To stem this unintended buildup of stocks, businesses cut back their orders for new goods, and repercussions were felt throughout the economy. In addition, the widely predicted decline in the dollar's strength never materialized; instead, the dollar gained record strength. Consequently, exports lagged, braking the speed of expansion even more.

Fundamental strengths persisted through the slowdown, and signs of improvement began to appear as early as October and November. It now seems clear that the weakness in the third quarter was part of a transition from the unsustainably rapid growth in early 1984 to a more sustainable pace in 1985.

Indeed, the rapid growth of the first half of last year bore troublesome inflationary implications. For example, capacity utilization rose to over 80 percent, a level many economists believe cannot be sustained without creating bottlenecks that drive up prices. Consequently, some slowing seemed necessary, although, like most people, I was surprised by its abruptness. Fortunately, even during the weak third quarter, most of the important underlying economic conditions remained positive. Personal income, for instance, continued to grow at an annual rate of about 4 percent, and personal savings rose as Americans spent less of their increased incomes on consumer goods. Inflation remained around 4 percent throughout the year, a low level given the robust expansion in early 1984. Business investment slowed in the third and fourth quarters but remained essentially strong. Finally, interest rates began to fall late in 1984. By year-end, a number of indicators were already displaying renewed strength.

Thus, the fundamentals seem to be in place for healthy growth in 1985, although at a slower pace than in 1984. Consumer purchases, investment by businesses, and expenditures by the government all should contribute to making 1985 a good year, with real GNP growth probably in the range of 3 to 3.5 percent. Consumer spending is likely to rebound since personal income and employment continued to grow even during the lull. Business spending on capital goods should continue to fuel expansion in 1985, even though the growth rate in business investment, like that of consumer spending, probably will be slower than in 1984. Last year's legislation modifying the tax treatment of business investment did not substantially alter the favorable climate for spending on capital goods established by Congress and the administration a few years ago. Ironically, recent Treasury Department tax reform proposals, which would eliminate many special provisions designed to spur investment, could actually stimulate investment in equipment this year. Some businesses may try to take advantage of such provisions before they are rescinded.

A third source of short-term strength is fiscal policy, which is highly stimulative. Defense spending in particular should help maintain momentum in the the nation's factories, even if the defense budget is cut along with other federal programs. Military projects approved in the past few years should maintain strong activity through at least 1985 and possibly into 1986. Another source of stimulus is the interest rate decline late in 1984. Reduced credit costs should spark at least a temporary revival in residential housing by attracting buyers back into the market and making it relatively cheaper for builders to undertake new projects. Finally, while monetary growth did weaken for several months, particularly in the case of M1, recent numbers show a substantial rebound. In fact, M2 and M3 have been expanding rapidly in the past few months.

Of course, some potential problems and weaknesses loom in the months ahead, and certain sectors of the economy are less likely to join in the expansion this year. The construction industry will probably show mixed patterns in 1985. Much of the pent-up demand for housing has been filled. Remaining demand will probably be rather sensitive to mortgage rates. Multifamily building may have grown faster than demand in 1984. Apartment vacancy rates are high in many areas, and the stock of unsold condominium units is also substantial. Nonresidential construction should continue its momentum, but I am concerned about commercial building. Office vacancy rates in many cities are worrisome.

Another important area of continuing weakness is the international sector. The high exchange value of the dollar and the slower recovery abroad have sapped considerable strength from American manufacturing. Producers of textiles, apparel, lumber, and other goods sensitive to foreign competition experienced weak growth in 1984, and their condition probably will not improve in 1985. In addition, industries heavily dependent on exports, such as agriculture and machine tools, cannot hope for much stimulus from foreign demand. Even if the dollar were to decline, it would take time to have a substantial effect on trade patterns.

Because of these weaknesses and the likelihood of slower growth in consumer spending and business investment, unemployment will probably decline much less this year than it did in 1984. Still, I am quite hopeful that it will fall below the 7 percent mark. Also, at this mature stage of a business expansion, the anticipated resurgence of growth could possibly produce a somewhat higher inflation rate, probably in the neighborhood of 4.5 to 5 percent. Overall, though, I look for respectable economic growth consonant with this stage of the business cycle.

Problems

I am basically optimistic about the future, but some problems — inflation, unemployment, real interest rates, the deficit, and international trade — still exist. Price increases did decelerate dramatically in the early 1980s and have remained a moderate 4 percent despite the recent, rapid economic growth. Nonetheless, little more than a decade ago 4 percent was deemed sufficiently high to warrant wage and price controls. Clearly, we have room for more improvement on this front.

Similarly, our recent progress in reducing unemployment is cause for enormous satisfaction, but the current 7.2 percent jobless rate is still unacceptably high. Moreover, unemployment remains much higher in many industries and areas, including parts of the Southeast. Certainly, we must strive to lessen the human suffering and unrealized economic potential implied by these statistics.

A third problem is our high level of real interest rates. High real interest rates increase business costs generally and discourage investment. Consumer demand for houses, autos, appliances, and home furnishings is also dampened. The large federal deficit seems likely to remain a source of upward pressure on real interest rates. Even adjusted to the level that could be expected if we had full employment, the deficit is now over 3 percent of GNP, compared to about 1 to 2 percent in most of the 1970s. This burden will carry over to future generations. We are obligating our children and grandchildren to save more and to pay higher taxes because of our unwillingness to live within our means.

Deficit problems affect not only domestic financial markets but also the international sector, as high real U.S. rates make dollar-denominated investments more attractive to foreigners. The higher return from holding dollars raises our currency's exchange rate and thereby worsens our trade deficit. I have already mentioned that the dollar's strength is hurting American exports and increasing imports sharply, exacting a considerable toll on American manufacturers in a wide variety of industries ranging from labor-intensive apparel mills to capital-intensive steel mills. Our 1984 trade deficit totaled a record $123 billion — far above the previous record of under $70 billion.

A continuation of the current international situation could revive protectionism. Many firms are holding on by a thread, hoping the exchange rate of the dollar will decline. It is understandable that such firms would welcome protectionist measures to help them ride out what most economists view as an abnormal situation. However, protectionism by one country inevitably is followed by countermeasures in others. Moreover, by postponing necessary reforms, protectionism ultimately weakens the very businesses and workers it is intended to protect. Another adverse consequence of protectionism today could be to snuff out the weak economic recovery in many developing countries by reducing their access to American markets, eliminating a major source of the limited growth they have achieved.

The situation in developing nations is also important because many of them are heavily indebted. While default by a third-world nation is highly unlikely, LDC debt problems require careful consideration as we seek to correct domestic economic problems and promote growth in the United States.

Let me conclude my remarks on the economy where I began. This will be a year of strong economic growth, with relatively low inflation and unemployment. There are and always will be dangers, problems, and uncertainties. But I am an optimist, and I think we optimists have proven over time to be the realists. I really believe the future holds promise. We are at the threshold of a new world, but we are also at a crossroads. If we can solve our problems, we have the chance to create an economy and a society that will provide unparalleled prosperity for us, our children, and our grandchildren in the years ahead. I believe we have the wisdom and the will to succeed.