INTERSTATE BANKING TODAY AND TOMORROW

Remarks of
Mr. Robert P. Forrestal
President
Federal Reserve Bank of Atlanta
to the
Shearson Lehman Brothers, Inc., Interstate Banking Seminar
New York, New York
May 17, 1985

It's a real pleasure for me to be here with you institutional investors this morning to lead off this seminar on interstate banking. Among the many profound changes taking place in today's financial services industry, certainly one of the most significant is the move toward banking across state lines. I would like to talk about the forces underlying these changes and what they imply for future policy decisions.

Banking—Today Versus Yesterday

In order to see where financial services and, among them, interstate banking are headed in the years to come, I think it's a good idea to look around and see where we stand today compared with a decade or two ago. If a banker whose work experience spanned the years from the 1930s to the 1960s were, like Rip Van Winkle, to awaken today from a 20-year slumber, he would scarcely recognize his old profession. This old-timer would discover that while he was napping, market forces had changed the regulated world of the past into one that requires much more creativity and less adherence to procedures. Not many years ago, the world of depository institutions was surrounded by a fence posted liberally with "no trespassing" signs. Within that fence were walls that neatly segmented the various types of depository institutions. You could tell them apart a mile away: savings and loan associations could not offer checking accounts or anything resembling them. Neither could credit unions. Commercial lending was reserved strictly for bankers, but virtually all aspects of investment banking, including brokerage services, were off-limits to commercial banks.

The institutions within that fence were closely regulated. Rigid limitations restricted their freedom to establish branches or other offices, and banks' markets were generally confined to their own states or even to certain counties or regions within those states. Other inflexible restrictions regulated their ability to expand product lines. Legal ceilings created a cap on the level of interest rates banks could pay on various kinds of deposits, dampening any competition that might emerge. During this long period of shelter from outside competition, financial institutions were almost guaranteed a profitable operation if they complied with regulations, did their arithmetic carefully, and offered a reasonable level of service to their depositors. Banks did not chafe at their geographic limitations, or they did not mount pressures to remove such limitations, in large part because their local and state markets tended to provide good profits within the sheltered regulatory environment. Competition within the enclosure was muted, and potential competitors showed little desire to offer financial services and, thus, penetrate the regulatory fence. The friction introduced by interest ceilings made the situation appear stable for a while since these limits deterred nonbanking financial institutions from entering the markets traditionally dominated by banks.

Today, the situation is quite different. Some gaping holes have been torn through that once-protective fence. Many of the "no trespassing" signs have been trampled down, and the walls within that fence have been breached so often that many depositors forget they ever existed. The first major change to occur involved the type of businesses offering financial services. Starting in 1973, nonbanking financial service companies began offering money market mutual funds. These interest-bearing accounts were a close substitute for bank deposits, and their popularity accelerated sharply in the latter half of the 1970s. The institutional expansion of financial service providers has not been limited to nonbanking financial companies. Even nonfinancial companies, such as

Sears and the finance company subsidiaries of GM, GE, and other manufacturers, have played an increasing role in the line of commerce that was once the exclusive domain of banks. Such companies have expanded beyond their traditional roles of financing the products of their parents and are competing more and more in the markets once dominated by commercial banks.

This expansion of financial markets through new entrants has occurred in tandem with product expansion. Institutions have circumvented the old restrictions on product lines. Banks and thrifts have money market deposit accounts and Super NOW accounts with which to compete against money market funds, and they have had some success in drawing back deposits formerly lost to nonbank financial institutions. Some banks offer discount brokerage services. Thrifts and credit unions offer checking accounts, and a myriad of financial instruments and services is available to the consumer. Many banks and thrifts are clamoring to offer additional products such as insurance and revenue bonds.

A third major difference between today's and yesterday's financial services industry pertains to the character or style of business. The industry seems to have lost some of its staid and stable character. In the last two years the number of bank failures has increased sharply, from about four per year in the sixties and about eight per year in the seventies to 48 in 1983 and 79 last year. These failures occurred at FDIC-insured commercial banks. What's more, the 1984 figure does not include the virtual failure of one of the nation's largest banks. More recently, several firms in the government securities market have failed, leading in one case to problems with Ohio's S&Ls. These problems were of sufficient magnitude to alarm depositors and financial markets here and abroad.

Another, and very important, change has been in the area of geographic expansion. Interstate banking has been spreading rapidly. By the end of this year we will find banks from about one-third of the states operating deposit-taking offices in at least 40 states. What's more, individual states have adopted laws that allow out-of-state banks to operate within their borders, further weakening geographic limitations. In all, about half the states have approved laws of this type, and more than one-fifth have adopted regional reciprocal interstate banking laws. These states are concentrated primarily in New England and the Southeast. Many thrifts are also marketing their services across state lines, not just in contiguous states but across the country.

Forces of Change

How did all this happen? How and why did our traditionally conservative sector of the economy undergo such dramatic changes in such a short time? As I see it, three fundamental forces account for these changes. These are inflation, technology, and competition, with its attendant pressures for deregulation. Market forces and inflation deserve much of the credit—or blame, depending on your perspective—for interest rate deregulation. The acceleration of inflation in the 1970s began to make traditional savings accounts, with their interest rate ceilings, look less appealing to depositors. Who could get excited about earning 5 1/2 percent when inflation was shrinking the buying power of deposits faster than the accrued interest increased their nominal value? Investors sought and found opportunities to earn more. Some unregulated and quite innovative businesses on the other side of the fence recognized the opportunity and conceived the money market fund.

Since those outside businesses were free of the regulations limiting banks and thrift institutions, they could offer depositors market rates of interest on funds placed with them. The result was inevitable: investors searching for more lucrative returns began to remove their deposits from depository institutions and to swell those money market funds. The fence that once seemed to shelter the regulated depositories quickly began to look more like a prison wall. Banks could not win at their own game. These competitive problems faced by traditional financial institutions generated momentum for the drive to liberalize government regulations. Many regulatory restrictions have been eliminated. Today, the deregulation of interest rates on deposits is virtually complete. Only passbook savings accounts, NOW accounts, and, of course, demand deposits are limited by interest ceilings. Ceilings on all interest-earning accounts will be eliminated on or before March 31, 1986.

At the same time that deteriorating legal barriers and intensifying competitive pressures have been transforming the financial services industry in dramatic ways, a technological revolution has been taking place in our payments system. These technological changes also contributed significantly to the evolution of financial services and the expansion of interstate banking. ATMs and other computerized services put customers and financial institutions in touch more quickly without the personnel and capital expense of bricks-and-mortar branches. Thus, the physical branch system of banks and S&Ls, one of their unique features, has become less significant. Moreover, banks' direct access to the payments clearing mechanism has lost some of its importance. Although checks and cash will remain important into the foreseeable future, paperless transactions involving wire transfers and automated clearinghouses are growing far more rapidly. Networks linking automated teller machines are offering consumers unprecedented convenience. For example, travelers a thousand miles away from home

can withdraw or borrow cash after regular business hours. In this way, some banks have been able to reach new customers across state lines.

Inflation, competition, and technological innovation have thus contributed in important ways to the spread of interstate banking. Although the legislative barriers to interstate banking still stand, banking across state lines has, nonetheless, emerged as a marketplace reality. The basic federal law governing bank branching, the McFadden Act of 1927, limits national banks to branching within the states, subject to state restrictions on interstate branching. The Douglas Amendment to the Bank Holding Company Act of 1956 prohibits interstate expansion through acquisitions of banks in another state unless explicitly authorized by that state. Despite these statutory constraints, firms ranging from banks and thrifts to supermarkets and general merchandisers are offering a mixture of financial services through offices scattered from the Atlantic to the Pacific. To do so, they are using a variety of strategems—including such devices as loan production offices, bank holding company subsidiaries, and the so-called "nonbank banks." If we count the number of offices of foreign banks, Edge Act corporations, loan production offices, and other nonbanking subsidiaries of banks and bank holding companies as well as grandfathered interstate banking offices that are operating across state lines, the number of interstate offices offering various types of banking services totals almost 8,000! When you compare this figure to the number of commercial banks in the United States—a total of 15,000 with 55,000 offices engaged in full-service banking, you can see that we have an enormous amount of interstate banking already. And those numbers don't include such interstate banking services as credit cards with lines of credit available to customers across the nation as well as lockbox operations and private sector check-clearing services.

Some of the latest proliferation of interstate banking offices has occurred as a result of a statutory loophole—the 4 (c) 8 clause of the Bank Holding Company Act that defines a bank as an institution that accepts deposits and makes commercial loans. That clause was interpreted to mean that subsidiaries which engage in one, but not both, of these two functions could legally offer such services across state lines. This either/or interpretation gave rise to the term "nonbank bank," with which you're all now quite familiar. I sometimes awaken from a dream, or perhaps a nightmare, in which a non-Fed Fed is trying to oversee these nonbank banks. After a lengthy period of legal wrangling, and after it became apparent that Congress was not likely to address the issue anytime soon, the Comptroller of the Currency last fall approved a number of long-pending applications for nonbank bank charters. Over 100 were subsequently approved by the Comptroller, the chief regulator of national banks. However, a suit by the Florida Independent Bankers Association challenging the jurisdiction of the Comptroller over nonbank entities has brought the former flood of approvals to a standstill. The Supreme Court has also agreed to review a Fed action to broaden the definition of commercial loans in a way that would narrow the powers of nonbank banks. However, a decision won't be handed down until 1986. Thus, status of nonbank banks remains in legislative and judicial limbo.

Our legislators in Washington and in state capitals may debate the merits of these trends for a few more years, and they may influence the speed and course of interstate banking. Nonetheless, it is probably too late for legislators to stem the tide of interstate banking that is being propelled by market forces. The same is true of the judicial decisions pending. Early in 1985 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 the Federal Reserve Board's approval of mergers under state laws that limit such mergers to states participating in the New England regional interstate compact. The Supreme Court could rule in three ways: (1) to allow regional compacts, (2) to disallow regional compacts, or (3) to find the Douglas Amendment unconstitutional, thereby opening the doors to full interstate banking now. Thus, this decision is of particular interest to bankers and policymakers in the Southeast, of course, but it will also be watched closely by legislators from other states such as Oregon, where regional interstate banking is under contemplation. It could have implications for the merger of Florida's Sun Bank and Trust Company of Georgia as well since Citicorp has also filed suit in the U.S. Court of Appeals for the Second District in New York to block the SunTrust merger.

It is difficult to predict when the Supreme Court's ruling may be issued, although present indications are that a decision could be forthcoming by late July. Even if the case were delayed until the fall term in October, however, interstate deposit taking would not necessarily slow. A recent Federal Reserve Board proposal to allow bank holding companies to provide certain administrative and back-office services to their nonbank bank subsidiaries would sustain the expansion of interstate activity even without regional compacts. This proposal would permit out-of-state nonbank banks to include data processing and bookkeeping services under the umbrella of activities that holding companies could perform for their nonbank bank subsidiaries. It would also permit holding companies to share officers and directors with their nonbank subsidiaries. In addition, it would preserve any trust service agreements between trust companies and subsidiaries converted into nonbank banks. This proposal is still just that—a proposal. Yet, its consideration by the Fed reflects the strength of competitive market forces that are working toward greater efficiency in the financial services industry. Thus,

its existence even as a proposal implicitly provides further evidence that interstate banking is here to stay.

The Future of Financial Services

Where are financial services going? As I see it, four major forces will shape the course of tomorrow's financial services industry. These are macroeconomic growth, further increases in competition, regulatory changes, and even more exciting technological innovations. Clearly, macroeconomic factors will play an important and, I believe, positive role in determining the direction taken by banks and other financial institutions. Provided progress can be made toward lowering the very large federal budget deficit, the U.S. economy is likely to grow at a healthy pace over the next decade. Such growth should help mitigate problems such as the high incidence of financial failures. This expected expansion will also increase demand for all kinds of financial services, thereby creating an environment of growth and opportunities for financial institutions.

Since this sort of macroeconomic growth will require a stable as well as a highly developed and responsive financial system, we will probably experience some changes in the regulatory environment to ensure the continuing soundness of our financial system. Increases in bank capital ratios have already been enacted. We may see a change in deposit insurance. Critics of the present system have proposed deposit insurance fees based on risk, strict limits on payoffs for failed institutions, private co-insurance, and more intense supervision. The thrust of recommendations put forth by regulatory agencies other than the Federal Reserve is to place more risk on depositors. Under these various proposals, depositors would bear more of the cost of risk either because institutions would be charged for their riskiness and pass the added costs along to

customers or because insurance coverage would be limited. In either case, more of the burden of assessing risk would fall on banks' customers. None of the proposals is free from bugs; none is terribly attractive. I believe that there will be some reform, however.

Notwithstanding the probability of some regulatory reform, I believe that the major thrust will be toward further deregulation. Laws and regulations, no matter how well thought out, are proving to be flimsy indeed when pitted against market forces that push money flows into their most profitable uses. Within five to seven years, I feel, banks will be able to operate across state lines nationwide, and new powers will enable banks to offer customers a wider range of services. External competition will continue from Sears, Kroger, Merrill Lynch, American Express, and other nonbanking companies as well as from foreign institutions.

Another force for continuing change in the financial services industry is technology. The wave of new technology will allow financial institutions, both large and small, to operate more efficiently, substituting ATMs, point-of-sales payments systems, and the like for bricks-and-mortar branch offices. Home banking, utilizing the family's personal computer, may also become a reality as technological advances make it cheaper and more affordable to a wide range of households. What's more, computerized home banking seems likely to foster ever more interstate banking.

Interstate Banking: The Next Stage

These forces for change in the industry will, in my view, sustain the momentum for the continued expansion of interstate banking. Opposition is likely to remain strong in some quarters, especially among banks that are concerned about their capacity to

remain operating as independent institutions. However, the underlying market pressures are very strong and unlikely to be staunched by regulatory patchwork. Three objectives should guide policy as we move toward the next stage of interstate banking. These are (1) preventing excessive concentration of economic resources, (2) protecting the safety and soundness of the banking system, and (3) maximizing the benefits to be gained by consumers.

Traditionally, interstate banking has been discouraged in the United States because of a fear of concentrated financial resources in the economy. In addition, the historical importance of small business and America's federal form of government have generated support for the perpetuation of local banks which are better positioned to assess the needs of smaller businesses in their respective communities. In recent years the concentration argument has lost much of its persuasiveness. Studies have shown that beyond $75 to $100 million in assets there do not seem to be economies of scale that would favor larger institutions over smaller ones. Moreover, in states such as California and New York, where statewide branching has been permitted for some time and which have some of the largest banks, the number of small banks has either been growing or at least not declining significantly despite competition from much larger institutions. The reason may be that community banks offer better services to their customers and are, in fact, more knowledgeable about local credit needs and customers.

The expansion of interstate banking will probably lead to somewhat greater concentration than at present. However, banking resources in the United States are much less concentrated than in other countries. The 100 largest banking organizations control only slightly more than half of all domestic banking assets. However, America's tradition of independent community banks and their built-in advantages make it unlikely

that the logic of our financial services industry would lead to the degree of concentration found in other developed economies. Moreover, legislative safeguards could limit whatever natural tendencies toward concentration there are. These statutory constraints could take the form of ceilings on market shares or total assets that any one institution could obtain through acquisitions or mergers, allowing for certain exceptions such as takeovers of failing institutions. The second consideration, protecting the safety and soundness of the nation's banking system, can be achieved through prudent transitional programs, a guarded approach to the expansion of powers, and adequate capital requirements and other measures designed to prevent excessive risk-taking by institutions seeking to expand geographically. The third consideration, maximizing consumer benefits, should be well served by the increased competition that will arise from interstate banking.

There are three policy avenues through which interstate banking seems likely to expand—the proliferation of regional interstate compacts, full nationwide reciprocity, and further use of the nonbank bank loophole. Of the three, the last is the least preferable, in my opinion. Over the years an elaborate safety network consisting of such measures as insurance systems and special legal and fiscal advantages has been constructed for banks and other financial institutions. The regulatory barriers to which I referred earlier were also part of this network. The reason for their creation and preservation over the years was the critical role banking and finance play in an advanced economy. These protections were never intended to apply to the vast majority of commercial enterprises in our economy, yet the stability of our economic system would be jeopardized by removing them from the financial sector. One of the main problems with the nonbank bank loophole is that it permits institutions to use this safety net without offering the full contingent of financial services for which it was initially

designed. Nonfinancial institutions might well be prone to undertake a degree of risk that is not consonant with the protective measures designed for full-service banks.

Thus, I believe that interstate banking should not advance through the interstices of federal banking legislation. Indeed, I feel that Congress should act expeditiously to close this loophole. Such legislation, if sufficiently comprehensive, would rebuild the battered barrier between finance and commerce without rolling back the many advantages to the consumer and the economy in general that have occurred as the result of deregulation. To be effective, Congressional action to close this back door for commercial establishments into the financial services industry must also preclude the formation of nonthrift thrifts. If Congress fails to include such a provision, commercial firms could well move headlong into the thrift industry, especially since it offers some official advantages over banking such as the current right to branch across the nation.

A second way interstate banking might continue to expand is through the proliferation of regional interstate banking compacts. More than half of the states in the nation have enacted or are actively considering such legislation. I believe that such regional compacts may, if they prove constitutional, serve a useful function in the transition to interstate banking primarily because they give local institutions time and resources to gear up for full competition with the large money center banks. They also can serve as pilot programs that allow us to examine in a more extensive yet still limited way the risks and uncertainties of greater interstate banking. Since our judgment that interstate banking poses few dangers and many benefits is based on inherently limited empirical evidence and actual experience, we could benefit substantially from this sort of tempered, experimental approach. However, interstate banking should allow us to achieve more efficient capital markets. This basic goal implies that market

segmentation by region is not a realistic long-term policy option. We must ultimately allow full nationwide competition rather than a permanent situation wherein the largest banks are excluded from many regions and the U.S. economy is inefficiently divided into markets defined by arbitrary political boundaries.

For this reason, I prefer the third approach, full nationwide reciprocity, phased into existence over a period of years in order to assure an orderly evolution of our banking system. This transition could be effected through a trigger system, whereby regional compacts must eventually give way to full nationwide reciprocity. Probably the best way to bring about such a trigger mechanism would be for Congress to enact enabling legislation along those lines. Congress could authorize interstate banking while still preserving some of the essentials of our traditional dual—state and national—banking system by requiring states that enter regional compacts to open their markets after a fixed number of years. This type of legislation would also allow states to remain closed if they so chose, but they would have to remain closed to regional as well as to national interstate banking. If Congress takes the sorts of actions I have outlined, I believe that in the aggregate parties directly affected by expansion of interstate banking will suffer fewer adversities of adjustment and the benefits to consumers will accrue in a more rapid and more systematic way.

Conclusion

Let me conclude by recalling how exciting it is to be part of today's financial services industry, with all its changes and challenges. Despite the sometimes intimidating nature of these developments, there are greater opportunities as the financial services industry becomes less regulated, more diversified, and more dynamic. The rise in interstate banking is not likely to be reversed because the market forces propelling it

and other changes are simply too strong to be negated by regulatory engineering. Nor should they be thwarted. I believe most of these changes, including interstate banking, are altering the financial services industry in ways that have the potential to benefit consumers, shareholders, and the economy as a whole by increasing the efficiency of our capital markets. The task of regulators such as myself should not be to block these changes but rather to ease the difficulties of the transition from the interstate banking system we already have to that of tomorrow.