INTERSTATE BANKING IN THE SOUTHEAST
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Introduction

Good morning! It's a real pleasure to be here and to have the opportunity to talk about interstate banking in the Southeast. In order to see where interstate banking is headed it is necessary to understand the changes that have been taking place in the financial services industry nationally. To get a feeling for the future of interstate banking in this region it is essential to know what the economic performance of the Southeast has been and is likely to be in the years ahead. This morning I'll be talking about both of these subjects. My coverage will necessarily be somewhat cursory, but I understand we'll have substantial time afterward for questions and answers. So perhaps at that time we can take up particular issues in greater depth.

Recent Changes in Financial Services

In the last decade or so the financial services industry has undergone more dramatic changes than at any time since the Great Depression. These are too numerous to list, but they fall under three broad categories—declining institutional segmentation, accelerating product innovation, and heightened geographical competition. The first development—reduced institutional segmentation—is widely in evidence. Thrifts can now provide many of the services once reserved for commercial banks; credit unions can offer a near equivalent of checks; and nonbanking financial companies have made considerable inroads into the traditional market of banks and savings institutions by offering money market mutual funds. At the same time banks have gone well beyond their historical boundaries by offering discount brokerage services at home and underwriting insurance and securities abroad. New product development has occurred in tandem with, and

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probably has amplified, this breakdown of institutional barriers. The money-market mutual fund is an obvious example, as are NOW accounts and money market deposit accounts, which banks and thrifts developed to compete against money market funds.

The third change, interstate banking, has also become widespread despite the McFadden Act, which limits national banks to branching within their headquarters state, and the Douglas Amendment to the Bank Holding Company Act of 1956, which prohibits interstate expansion through acquisitions of banks in another state unless explicitly authorized by that state. Interstate banking has developed in two ways. Much of it has been on a de facto basis through nonbank subsidiaries of bank holding companies, loan production offices, Edge Act Corporations, and branches of foreign banks. If we count all these operations, along with 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, compared to some 55,000 offices engaged in full-service banking. Problems in the thrift industry have motivated regulators and legislators to relax restrictions on interstate activities by thrifts and even by banks that purchase ailing thrifts. In addition, even some nonfinancial companies have engaged in interstate banking of sorts through the so-called nonbank-bank loophole. By either making loans or taking deposits, but not both, they have avoided classification as banks and, with it, the geographic restrictions and other regulations that apply to banks. At the same time, interstate banking has also spread on a de jure basis. Many individual states have adopted laws that allow regional reciprocal interstate banking. Banks from about one-third of the states are operating deposit-taking offices in at least 40 states, and almost half the states have adopted regional reciprocal interstate banking laws.

These three changes in financial services have been propelled to a large extent by the same causes. Market forces are responsible for much of the pressure to allow

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financial institutions to cross over into each others' formerly exclusive domains, whether geographic or institutional. Initially this competition was sparked by the high inflation of the 1970s. Yet even now that price increases are moderate, the forces of competition remain. Technology has played a key role as well, especially in the expansion of interstate banking. ATMs enable some banks to reach new customers across state lines. Other computerized services put customers and financial institutions in touch more quickly without the personnel and capital expense of bricks-and-mortar branches.

When we look at interstate banking in the broader context of what has been happening in the financial services industry generally, it becomes clear that the pressures for further geographic competition are not likely to abate; rather, they will probably intensify. Future technological advances, such as less expensive home banking utilizing the family's personal computer, are also likely to foster the spread of interstate banking. Within five to seven years, I feel, banks will operate across state lines nationwide whatever legal and regulatory tack we take.

Current Policy Issues

Of course, the expected expansion of interstate banking will not follow a predetermined course. Policy directions are still being hotly debated. In this controversy three public policy issues are paramount—(1) fear of excessive concentration, (2) concern for the safety and soundness of the banking system, and (3) interest in 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 regulatory support for local banks, which, proponents argue, are better

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positioned to assess the needs of smaller businesses in their respective communities. Interstate banking, in their view, would favor large institutions at the expense of smaller ones and lead ultimately to a potentially dangerous concentration of financial power and to the demise of many valuable community banks. 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, recent experience in California and New York bodes well for small institutions. In those states, smaller banks have held their own or even expanded despite the fact that statewide branching has been permitted for some time and competitors include some of the largest banks in the country.

It is true that 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. Moreover, legislative safeguards could limit whatever natural tendencies toward concentration there are. These statutory constraints might take the form of ceilings on market shares or total assets that any one institution could obtain through acquisitions or mergers. Of course, certain exceptions such as takeovers of failing institutions may have to be permitted.

The second issue currently being disputed is grounded in the concern that a very rapid shift toward interstate banking could cause considerable dislocations in the economy as financial institutions rush into markets without substantial experience and expertise. Although deregulation in other industries such as transportation and communication resulted in only limited imbalances, we know the banking and the financial services industry generally play much more of a keystone role in advanced economies. Consequently, even minor problems can quickly escalate into major ones. Banks and other depository institutions have many new powers and products already,

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increasing the potential risks to banks and making the job of supervision more complex and challenging. I believe that this issue is one deserving of careful consideration. In that regard, my own views favor protecting the safety and soundness of the nation's banking system by implementing prudent transitional programs, taking a guarded approach to the expansion of powers, and requiring adequate capital and other measures designed to prevent excessive risk-taking by institutions seeking to expand geographically.

The third issue--whether consumers will be well served by the increased competition that would arise from interstate banking--is a complex one. On the whole, I believe such increased competition would benefit consumers by resulting in more and better services at lower prices. Some hold the view that interstate banking might bring only temporary benefits to consumers. Proponents of this view fear that local capital markets will dry up as smaller institutions are absorbed, thus leaving many towns and communities worse off than they were before. My own opinion with regard to this argument is already apparent from my earlier remarks on the issue of concentration, which I don't believe will advance as far as some fear. In addition, I would like to emphasize that we already have national capital markets. Their existence has helped maintain many small institutions which could not obtain adequate funds locally to finance worthwhile projects.

The real concern for consumers, as I see it, is whether interstate banking will stop short of a truly efficient system. If our current regulatory framework and reforms are allowed to continue in an ad hoc manner, we could find ourselves with an interstate banking system that keeps out some of the largest institutions or that excludes portions of metropolitan populations living across state lines in regions not covered by a regional compact. This problem might seem peripheral, but there are at present 35 metropolitan

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areas whose residents and businesses are located in at least two states. We must give serious attention to directing interstate banking in a way that enables all consumers to benefit.

Alternatives

There are several policy avenues through which interstate banking could expand: (1) branching throughout metropolitan areas which extend across state lines, (2) expansion into contiguous states, (3) the proliferation of regional interstate compacts, (4) full nationwide reciprocity, and (5) further use of the nonbank-bank loophole. If our goal is efficient capital markets, then our ultimate policy objective should be, in my opinion, full nationwide interstate banking. The ideal way to reach this objective, I feel, would be through federal legislation that set a date for full nationwide interstate banking while authorizing regional compacts in the interim. Full interstate banking could occur by allowing both de novo expansions and acquisitions into metropolitans areas larger than some minimum size or primarily by de novo expansions with only limited acquisitions of small institutions permitted.

Of the other alternatives I have outlined here, I view the expansion of the nonbank-bank loophole as least preferable. Over the years an elaborate safety network consisting of measures such as insurance systems and special legal and fiscal advantages has been constructed for banks and other financial institutions. The reason for their creation and preservation 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

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without offering the full contingent of financial service and thus allows them, to some extent, to gain an unfair advantage over most banks.

My preference among these alternatives is for regional interstate compacts with a two- or three-year trigger, whereby full nationwide interstate banking would be permitted in those states which have enacted such compacts and a later national extension of interstate powers nationwide. I believe that regional compacts may 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. The importance of local banks, not just historically but also in today's more competitive environment, makes it wise to establish this sort of transition period. Regional compacts also could serve as pilot programs that allow us to gain experience with the risks and uncertainties of full interstate banking. Since our judgment that interstate banking poses few dangers and many benefits is based on limited evidence and actual experience, we could benefit substantially from this sort of tempered, experimental approach.

However, market segmentation by region is not a realistic long-term policy option. The basic goal of financial reform and change is to achieve more efficient capital markets. Therefore, regional interstate banking, which allows the largest banks to be excluded from many regions and inefficiently divides the U.S. economy into markets defined by arbitrary political boundaries, must be phased out eventually. Probably the best way to do so would be for Congress to enact enabling legislation that included a trigger mechanism. By requiring states that enter regional compacts to open their markets after a fixed number of years, Congress could authorize interstate banking while still preserving some of the essentials of our traditional dual—state and national—banking system. If Congress simply authorizes regional compacts with triggers without

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setting a date for complete nationwide interstate banking, we could see a contraction of interstate banking since many states might be unwilling to rewrite their regional reciprocal legislation along this line. 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 rapid and more systematic way.

Interstate Banking in the Southeast

What about the future of interstate banking in the Southeast? The Fed, of course, has no purely regional views on interstate banking. The policy recommendations I've just advocated pertain equally to the Southeast and New England as well as to other regions which have not enacted such widespread reciprocal compacts. It is really policy makers at the state level who are critical in setting the stage for regional interstate banking, and the southeastern states, along with those of New England, have been leaders in enacting such legislation. The next step—implementation of interstate banking within the existing legal framework—will be determined largely by the economic performance of this region. Interstate banking will probably spread more rapidly in states and regions whose economies are healthy and growing at a brisk pace. That means the Southeast will probably be the scene of much of the interstate activity that does occur. However, to date, cross-state banking activity has not proceeded as rapidly throughout the region as some experts expected. We do have some very large regional banks, but most of the interstate activity has been concentrated in Virginia, North Carolina, Florida, and Georgia. If recent experience is any guide to the future, interstate banking could remain concentrated in these southeastern states, which—not surprisingly—have grown rapidly and have good prospects for expansion in the years ahead.

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Economic Outlook

In view of the importance of local economic factors to the future of interstate banking in this region, let me conclude with some comments on the outlook for the southeastern states of the Sixth Federal Reserve District--Alabama, Florida, Georgia, Louisiana, Mississippi, and Tennessee. To a considerable extent what happens in the Southeast, especially in the near term, will be determined by what happens nationally and even internationally. Fortunately, the outlook for the national economy is better than it has been in some time. The economy grew at a rate of 3.7 percent in the first quarter, after adjusting for inflation—quite an acceleration over last year, when the expansion was just a little more than 2 percent on average. What's more, I think activity will pick up further toward year's end. Several developments underlie my optimism.

First, the decline in the value of the dollar in foreign exchange markets, which began a little over a year ago, is finally starting to have an impact. As the year progresses, we are likely to see a turnaround in the trade situation. We should be importing a little less and starting to export a little more. A second factor arises from current financial conditions. The stock and bond market rallies we've had increase consumer wealth and, with time, consumer spending. Rising equity prices also make it less costly for business to raise the capital needed for growth. With a better outlook taking hold, I would expect to see some expansion in investment by businesses in the months ahead. The decline in interest rates that has occurred is also quite auspicious. Fixed-rate mortgages have reached their lowest level since 1978. We have already seen their effect on the housing market, where starts are being sustained at an annual pace of about 2 million compared to around 1.7 million in 1985. Finally, the very large drop in the price of oil and energy generally should act as a tax cut, raising consumers' discretionary income. As the cost of gasoline and heating fuel falls, households have more to spend on other items, and they generally do spend most of this extra income

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rather than divert it to savings. Lower energy prices also reduce production costs for business and, indeed, help hold down prices generally.

On balance, the outlook for the U.S. economy is for a continuation, at a faster pace, of what is already a rather long expansion. GNP growth should be faster in the second half. Such expansion should bring the unemployment rate down and, due mainly to a fortuitous drop in oil prices, keep inflation modest. Thus, the near-term outlook for the Southeast is generally positive even though there are imbalances. The region's fairly large number of consumer-goods-producing firms will probably benefit from the stock and bond market rallies, lower interest rates, and the drop in oil prices since these developments are likely to spur consumer spending. Defense spending should also be a plus for many areas, including Atlanta, Florida, and parts of Alabama, Mississippi, and Louisiana.

Manufacturers who have been under intense competitive pressure from foreign producers may also see some improvement in the coming months as a result of the dollar's decline. Still, progress will probably be slow and halting for some of the area's import-sensitive activities such as chemicals, textiles, and apparel. Certain countries in which the chief foreign competitors of U.S. apparel and lumber producers are located have not experienced the sort of currency appreciation relative to the dollar that has characterized the movement of advanced economies' exchange rates over the last year. Canada's currency at present is nearly the same relative to the dollar as it was a year ago, whereas the yen and the Deutschemark have risen by more than one-third. Moreover, even if the Canadian dollar were to appreciate substantially, the effect on the Southeast might not be great. In this region import competition from Canada has been heavily concentrated in the softwood lumber market, which is important in residential construction. Unfortunately, a moderate realignment of U.S. and Canadian currency

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might not dramatically reduce the large market share our northern neighbors have gained because other factors make basic costs of this resource lower in Canada. The same can be said of Asian competitors in the apparel industry, who have an enormous labor cost advantage over U.S. manufacturers, an advantage that cannot be eliminated by any realistic currency realignment.

The outlook for those involved in natural resource extraction and processing is also rather bleak. I've already described the situation in the forest products industry. Drought is taking its toll on southeastern farmers. Lower oil prices can only spell bad news for the vast majority of the region's oil and natural gas industries, which are concentrated in Louisiana and southern Mississippi. What's more, the downward pressure on oil prices does not bode well for for Alabama's coal industry.

On the other hand, the service sector will probably continue to fare better than many goods-producing industries. One reason that services figure so prominently in southeastern economic growth is the influx of people to this region. New residents fuel demand for housing as well as such services as banking, restaurants, department stores, medical care, and airports. Tourism, another regionally significant service industry, stands to gain from the dollar's depreciation and the drop in oil prices.

Reviewing the sources of strength for the southeastern economy—defense expenditures, consumer spending, population growth, and the dollar's decline—Florida and Georgia seem likely to enjoy the brightest prospects in 1986, while Louisiana will probably remain weak. Tennessee, Alabama, and perhaps Mississippi, should fall in the middle. Generally, cities such as Nashville, Atlanta, and the numerous urban areas of Florida should fare better than rural areas. Most of the population growth—and hence service sector expansion—is taking place in metropolitan areas, whereas small towns and

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rural areas not only depend more heavily on agriculture but also face the challenge of finding new sources of jobs for many permanently displaced manufacturing workers.

In the longer term, prospects for the Southeast are generally bright because of the region's cost advantages, attractive climate, and its already established momentum that should generate ongoing in-migration of business, people, and capital. Nonetheless, some imbalances will probably remain as areas heavily dependent on import-sensitive manufacturing adjust to an increasingly global marketplace. Fortunately, in terms of sheer numbers those states with the best long-term economic outlook are also those with the most people. I'm referring, of course, to Florida and Georgia.

Conclusion

What this outlook implies for interstate banking in the Southeast is that most of the action is likely to continue in those states where geographic competition has already been keenest, that is, in those states with the best prospects for growth. However, I want to remind you that interstate banking will probably continue to expand nationally because of competitive pressures and technological forces propelling all the changes in financial services I outlined earlier. I believe most of these changes, including interstate banking, are altering the financial services industry in ways that will benefit consumers, shareholders, and the economy as a whole by holding down prices, spurring innovation, and increasing the efficiency of our capital markets. The task of regulators such as myself should not be to block these changes or to encourage them only in certain regions but rather to ease the difficulties of the transition from the interstate banking system we already have to that of tomorrow.

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