LESSONS FROM THE U.S. EXPERIENCE OF INTERSTATE BANKING
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Good morning! It is a great honor for me to be part of this conference that is designed to look ahead to one of the singular events of the twentieth century, the unification of European markets. That unification has been a dream that many have shared for years. On the way to realizing that vision in 1992, Europe will be bringing about unprecedented changes in its financial services industry. Banking in the United States has been going through a transition of its own over the past decade or so, one involving deregulation not only of the products banks can offer but also of geographical limitations to their activities. My objective this morning is to sketch the broad outlines of the latter facet of bank deregulation in America--that is, the interstate banking movement--in the hope that our experience might shed light on some aspects of the European effort.

One lesson from the American experience can be stated quite directly at the outset: what Europe is attempting to do is far from easy. Presumably one of the primary motivations for integrating financial markets here is to keep pace with the exchange of goods in the Common Market. We have had a common market for goods in the United States for 200 years, but we have yet to achieve full financial integration. Nonetheless, we are moving closer to that goal and will reach it for all practical purposes by 1992.

It is not merely a coincidence that both the United States and Europe are working to achieve greater uniformity of banking across long-standing barriers at about the same time. We are all being prodded by the same forces to evolve new relationships between the exchange of goods and services and the movement of capital. Technology and communications are reducing the time and costs of completing business transactions. If money markets are weighted down by restrictions left over from a time when trade moved at a slower rate, they cannot be effective in fulfilling their roles of providing funding and information to contemporary businesses.

In the interest of adding to the discussion of how best to make this transition in Europe, then, I will attempt to provide you with an overall picture of the interstate banking movement in the United States. I will begin with a brief historical overview of American banking regulation as it pertains to geographical restrictions and then offer a survey of the current situation and developments leading ultimately to full nationwide interstate banking. Finally, I will highlight what I feel are the lessons we have learned along the way that might be apropos to Europe.

The Historical Background of Geographical Regulation

The interstate banking movement in the United States is part of a general deregulation effort aimed at freeing banking from restrictions imposed at various times in the past. These restrictions have been of two general types--product and geographic. I will not go into the details of product deregulation here. It is, however, important to be aware of how these restrictions developed because they reflect the deep-seated American distrust of the concentration of financial power. Since the 1930s, in the wake of widespread bank failures, a sharp line has been drawn not just between banking and commerce but between commercial banks and investment banking. Despite liberalization in the last decade, particularly in the areas of interest-bearing accounts, the basic restrictions remain. Investment banks are prohibited from jointly undertaking the two basic activities of banks--taking deposits and making loans. On the other hand, commercial banks cannot underwrite most securities and insurance and especially are restricted from engaging in commercial activities.

The second kind of regulation, geographic restriction, has a history dating back to the early days of our nation. Initially, banking was governed primarily by the individual states rather than the federal government. The concept of state regulation was reaffirmed in the early years of the republic when the first two attempts to establish a central bank both ended in Congressional refusal to renew the banks' charters. These two banks--the First Bank and the Second Bank of the United States--had branches throughout the country. At the time, opposition to these banks stemmed from objections to the concentration of power in them and also from complaints of unfair competition from state-chartered banks, which could operate in only one state. When the Second Bank's charter was not renewed in 1836, commercial banking returned exclusively to the regulatory control of individual states. The states generally applied geographic restrictions within their own borders as well, and banking became an industry characterized by relatively small, locally oriented firms. Interstate banking virtually disappeared.

The American Civil War placed new demands on the financial system and at the same time intensified continuing needs for central banking functions. Manufacturing had grown in importance in the 1840s and 1850s. The nation's economy had also become more integrated, giving rise to new demands for a common currency and uniform banking regulations. More important, the federal government needed to raise funds to carry on the war. To meet those various demands, the national banking system was set up in 1863. By providing a channel outside the state governments for obtaining a banking charter, the National Bank Act accidentally established the dual banking system of state and national banks that survives to this day. The importance of the dual system is that it preserves states' rights in a federated structure in much the same manner as does the American system of government. It is thus a reflection of Americans' preference for a prescribed measure of local control in banking as in government. Despite their federal charter, national banks have always been constrained by the regulations of the states in which they operate. Until recently, then, neither state nor nationally chartered banks were permitted to operate across state borders.

Another vehicle for interstate banking did develop, however, as an outgrowth of bank holding companies. These companies had evolved slowly in the early years of this century, but picked up momentum as time passed. By the 1950s, a few holding companies were able to create sizable interstate banking and nonbanking networks, avoiding both the geographical and product limitations placed on banks. This development led to congressional attention that culminated in the Bank Holding Company Act of 1956. That law increased the Federal Reserve System's role in regulating bank holding companies and set standards of approval for future bank and nonbank acquisitions. An amendment to the act prohibited bank holding companies from acquiring banks in more than one state unless a bank targeted for acquisition was in a state whose law allowed it. That legislation brought Americans back to single-state banking, though a few "grandfathered" holding companies were permitted to maintain interstate operations.

One important addition to the dual banking system must be included in this survey. That is our savings and loan institutions. S&Ls, or "thrifts" as they are sometimes called, now have assets of about $1.25 trillion as compared to $2.85 trillion for commercial banks. They are separately regulated and are not bound by the Bank Holding Company Act. Thus, no federal prohibition prevents interstate acquisitions of one S&L by another thrift. Instead, their own regulatory body, the Federal Home Loan Bank Board, decides on interstate acquisitions. Whereas S&Ls for a long time were primarily concerned with the home mortgage market, many of the earlier distinctions between banks and thrifts have now blurred. Thrifts may now commit a certain percentage of their portfolios to auto loans and other types of consumer lending as well as commercial loans. Since they have more latitude in crossing state boundaries, these financial institutions may therefore have a role to play in the interstate movement. In addition, a proposal to allow banks to acquire healthy S&Ls across state lines is under consideration by the Federal Reserve Board of Governors. In recent years, banks have been permitted to make interstate purchases of failing thrifts but not solvent ones.

Despite the historical prohibitions against interstate banking I have discussed, I want to make it clear that the activities of banks did not necessarily stop at state borders. For one thing, the bank holding company regulations apply to corporations and leave individuals free to own banks in more than one state. For another, the regulations covering bank holding companies allow banks to carry on many "nonbank" activities across state lines if they are closely related to banking. Activities like offering and servicing mortgages and credit cards or providing financial data processing services have been considered acceptable nonbanking functions.

The Interstate Movement

Against that historical background, let us examine the development of the interstate banking movement. As we have seen, through the bank holding company channel, bankers have been able to grant loans and provide a broad spectrum of financial services wherever they wished for at least three decades. What they could not do, however, was to establish a physical presence in other states whereby they could take deposits. Bankers' interest in having this privilege coalesced with several other dynamics to initiate the interstate banking movement in the mid 1970s. One of those dynamics was a desire on the part of some states to allow banking activities within their borders to expand. Expansion, they hoped, would lead to better economic development or to sufficient growth among local banks that they could eventually compete with larger money-center banks. Second, the nonbank activities allowed to banks under the Bank Holding Company Act were already expanding at such a rate that many bankers began to feel interstate banking at the national level was inevitable. Yet another dynamic was banks' worsening competitive disadvantage vis-a-vis the many nonbank financial institutions that offered banking services.

Basically, these nonbank institutions sidestepped banking regulations by only carrying on one of the two functions that defined a bank according to the Bank Holding Company Act. That is, they either accepted demand deposits or made commercial loans but did not do both. The activities of nonbank institutions were a catalyst in the product deregulation movement as well as in the interstate movement. In the high-interest-rate and inflationary environment of the 1970s, large brokerage houses took advantage of new technology and advances in communications to introduce money market accounts and interest-bearing transaction-type accounts. Banks were unable to respond in kind and soon found themselves losing depositors. For this reason Congress enacted legislation in the early 1980s allowing banks to issue similar accounts. It also phased out ceilings on interest rates. Similarly, nonbank financial institutions faced no geographic restrictions in their operations, and bankers wanted to have a more equal footing in that regard as well. Unfortunately, Congress has not taken the initiative on the overall interstate banking question, in effect leaving the states to deregulate on their own.

The first such action in the interstate deregulation movement was undertaken by the state of Maine in 1975. This sparsely populated, economically languishing state in the far northeastern corner of the country was seeking ways to attract new sources of capital for in-state investment. To do so, Maine passed a law providing for general entry by out-of-state bank holding companies. This action was addressed to the provisions of bank holding company legislation that confined interstate banking to those states which specifically approved it. In 1982, Massachusetts passed a law allowing bank holding companies based in other states in the New England region to acquire Massachusetts banks provided that the other states offered reciprocal privileges. In the same year, New York offered bank acquisition privileges to holding companies in any state in the nation that reciprocated.

The laws of these first three states were prototypes of the three forms that 41 of our 50 states and the District of Columbia would follow in opening their borders to out-of-state banks. Following Maine's example, nine states and the District of Columbia allow unrestricted entry from any other state. Like Maine, some of these states hoped to attract new capital. Others, like Texas and Oklahoma, hoped to maximize the number of potential acquirers for troubled banks. Reciprocity was not a crucial issue to most of these states because they had few banks that were likely to expand into other states. Six states, including New York, permit acquisitions from bank holding companies based in any reciprocating state.

Twenty-six states have adopted some form of regional reciprocating laws after the fashion of Massachusetts, making the regional interstate compact the predominant form of interstate deregulation. In general, their purpose in enacting such legislation was to enable their local banks to expand while they were at the same time protected from acquisition by large money-center banks. Depending on how states are counted, some six regions have been created in this manner with varying degrees of success.

In many ways, the Southeast, which includes the six states of the Federal Reserve District that I represent, exemplifies the potential success of regional compacts. Reciprocal legislation by southeastern states has created a 14-state area. Since its inception, regionalization has led to a number of mergers and the creation of a handful of superregional banks located mostly in one portion of the region. In particular, some banks in Georgia, Florida, and North Carolina have engaged in mergers. One result of this activity is that the Southeast's big banks are now among the nation's largest. Indeed, they are too large for an easy hostile takeover by any other bank holding company.

Certain historical and cultural bonds make these states a more unified region than some others. Nevertheless, their arrangement shows signs of the weaknesses that make the regional interstate compact inherently unstable. Like the other regions, the

Southeast contains several states--Arkansas and West Virginia, for example--that belong to more than one zone. The existence of cross-over states illustrates the basic difficulty of determining which states should belong to a given regional compact. In addition, expansion-minded banks in Georgia and North Carolina may set their sights on states like Texas, which allows any bank to enter its market, once they have exhausted the possibilities for regional expansion. At this point, however, the attempt to protect regional organizations has the side effect of locking banks into their own regions and perhaps putting them at a competitive disadvantage with less constrained banks. At the same time it also limits the number of potential buyers for regional banks that wish to sell.

These flaws in the regional reciprocal form help explain why it can only be a transitional form. Many states have already recognized this transitory nature by instituting "national trigger mechanisms." These provisions say that on a specified date, varying in time up to July of 1992, they will allow nationwide banking. It is my opinion that states which lack trigger mechanisms run the risk of falling behind in the deregulatory movement.

Trends in the Interstate Movement

Despite the transitory nature of this state-initiated interstate banking movement, we have seen some trends emerge as a result of our deregulatory measures to date. One of these is that banking organizations attempt to enter states whose volume or growth of deposits make them attractive. For example, Georgia and North Carolina banks have been very aggressive in Florida, a state with a large deposit base and fast growth. On the other hand, Florida banks, which many expected to be equally aggressive outside its own borders, have not ventured outside Florida to so great an extent. It is true that several of the state's banks that might have expanded outside Florida may not have been in the strongest financial condition when the interstate law was passed. Nonetheless, it is also the case that Florida's banks were for the most part content to develop their own state market and had little incentive to seek deposits in other states.

A second general outcome of interstate banking has been that nearly all expansions have been by acquisition rather than by de novo entry. There are two main reasons for this. One is that banks prefer acquisition. A second is that barriers to de novo entry have been erected by many states. Laws in these states prohibit banks from being acquired before they have been in existence for a minimum number of years.

Because most geographic expansion is undertaken by large banks and is conducted through mergers and acquisitions, in the long run interstate banking appears likely to increase the concentration of banking assets in the nation. This tendency may present a problem for regulators since the United States has traditionally designed policies that avoid concentration. As I mentioned earlier, the fear of banking concentration to some extent underlay the rejection of nationwide banks in the 1800s. It was also one reason that the national banks and bank holding companies were repeatedly checked by interstate prohibitions. In recent years, however, banking concentration has been diluted in general by the activities of nonbanking institutions, which have taken the majority of markets for products like auto loans that were once the domain of banks. Thus even if the interstate movement tends to centralize banking assets in fewer banks over the long run, the economic impact of that concentration will not be as significant as it might have been, say, twenty years ago.

Despite the fact that we might see greater consolidation among larger banks, I do not agree with those who argue that interstate banking in the United States is a threat to small banks. I think we will probably end up with thousands of small banks and a few very large banking organizations operating in most major markets and holding a large share of the nation's banking assets. Those large organizations competing with each other in numerous markets throughout the country should, in my opinion, benefit consumers and commerce in general. To quiet fears of overconcentration, however, American policymakers perhaps might find it prudent to limit aggregate concentration by limiting mergers among the top 25 banks and to restrict the total percent of domestic deposits any one organization could hold.

Lessons of the American Interstate Experience

Having looked at the general features of American interstate banking and some of its early results, I will close by drawing together two "lessons," as it were, from the American experience. These lessons speak to the difficulties of what we are attempting to accomplish and at the same time to the advantages of doing it. One theme running through all my remarks this morning has been the continuing philosophical struggle with the notion of interstate banking throughout American history. After 200 years of first allowing, then rejecting, and then working around restrictions in a variety of ways, many of us believe that interstate banking has become inevitable and will be beneficial. The accelerating integration of other markets simply makes the inefficiencies of non-integration in financial services impossible to sustain. Yet we still have not taken a direct approach to geographic deregulation, and there is no clear indication that we will in the near future.

Perhaps our chief problem in finalizing this work has been the resistance of special interest groups. This is, of course, a problem that is created any time artificial protective barriers are constructed. It is always the tendency of protected parties--in this case local bankers who have profited from the inefficiencies of limited access markets--to seek to perpetuate the structures that give them competitive advantages. The move toward interstate banking requires the integration of numerous sets of rules by several legislative bodies. The dislocation this harmonization would entail tends to elicit opposition by affected groups. From where I sit in America, it is difficult to assess just how far Europeans have come in negotiating with one another as to what the final form of pan-European banking will be. However, it strikes me that Europe has probably not heard the last from its own special interest groups.

Whatever difficulties may present themselves, however, I feel that in the long run they are outweighed by the advantages of liberalizing interstate restrictions. Interstate banking will be a stimulus to competition. As such it should be beneficial to customers and to the financial services industry. First, it eliminates protected markets and makes capital flows more efficient. Second, by establishing a presence in areas previously unfamiliar to them, bankers can learn more about credit conditions in new places. This ultimately expands the information available to potential investors outside those areas at the same time it helps banks make loan decisions. Thus the sources of possible funds for local development are increased. Finally, competition among existing banks and the potential new entrants into local markets would also tend to enhance banking products and prices for all consumers.

Conclusion

In conclusion, let me emphasize one particular reason why we must press ahead with the work of deregulating the financial services industry, one that transcends the boundaries of either the United States or the European Economic Community. We must keep in mind that we are serving the purpose of a larger integration that is already in progress, and that is the integration of markets on a global scale. We are already feeling pressure to lower geographical boundaries to banking worldwide. The times now demand that we streamline our individual banking systems to adjust to rapid advances in the flow of goods and services. The need for greater efficiencies in the movement of capital will follow closely on the heels of the quickening pace of world trade. In the past, we have taken too much time in making the necessary adjustments; in the future, we cannot count on having much time to take. New technologies and communications will deny us that leisure. This means that our actions must be carefully reasoned in advance so that they can be timely and decisive. I trust that Europeans will be able to give us a model of a rational, orderly transition from national to international banking. Perhaps these lessons from the American experience will in some small measure assist in that task.