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economic commentary

Banking without Interstate Barriers

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In today's deregulated banking environment, more and more states are considering loosening their interstate banking restrictions. Ohio, Michigan, and Florida are three of about fifteen states currently considering interstate banking legislation. If such legislation were enacted, these states would join 15 other states that already allow some form of interstate banking. Most of the interstate banking laws are very restrictive as to who can enter and the powers of the entrants. States with the least restrictive laws include Alaska and Maine, which allow interstate banking with any state; New York, which allows interstate banking with any state that permits reciprocal entry; and Massachusetts, Connecticut, and Rhode Island, which allow banks from reciprocating states in New England to expand interstate and bar banks from entering from outside the region.[1]

According to interstate banking opponents, removing barriers to interstate banking might bring on the consolidation of the banking industry into a few large banks. An example of such concentration is Canada's banking structure, in which there are only 11 banks, each controlling on average about $25 billion in assets. However, advocates of interstate banking contend that geographic banking restrictions are anachronistic in today's financial environment. Interstate banking barriers are being rendered ineffective by technological advances such as electronic funds transfer. Banks are also placed at a disadvantage as they increasingly compete with nonbanking firms, such as Merrill Lynch, Prudential-Bache, and Sears, that market financial services through nationwide networks.

De facto Interstate Banking

Despite legal restraints on interstate banking, banking organizations and their subsidiaries have established extensive interstate networks in the past 10 years. In fact, except for taking in retail deposits, some banks perform virtually all of their banking functions on an interstate basis. In a 1982 study profiling interstate activities, banking organizations were found to control over 7,500 interstate banking offices, consisting primarily of loan production offices for commercial businesses, Edge Act offices for international banking activities, and nonbanking subsidiaries of multibank holding companies.[2] Interstate nonbanking subsidiaries of multibank holding companies numbered 5,000 and engaged in activities such as consumer and commercial finance, mortgage banking, leasing, loan servicing, and trust services. Currently, the nonbanking activity that is being aggressively pursued by larger banks is the acquisition of interstate industrial banks. An industrial bank is a state-chartered institution that can accept deposits and originate loans, but cannot offer checking accounts.

Interstate acquisitions of financially weak banks and thrifts are also eroding the barriers to interstate banking. An example of this is Citicorp's recent acquisitions of sizable thrifts in Chicago, Miami, and San Francisco, authorized by the Garn-St Germain Act. Such acquisitions in effect are back doors to interstate banking.

Also contributing to the development of nationwide banking is the tremendous growth of interstate automated teller machine (ATM) networks. Currently, there are approximately 200 regional and 7 national shared ATM networks.

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1. The state legislatures of Georgia, Utah, and Kentucky have recently approved interstate banking bills.

After two years, Rhode Island's statute will convert to national reciprocity.

2. See David D. Whitehead, "Interstate Banking: Taking Inventory," *Economic Review*, Federal Reserve Bank of Atlanta, May 1983, pp. 4-20.

Legal Restrictions on Interstate Banking

The federal legal restrictions on banks' geographic expansion are the *McFadden Act* of 1927, which was amended by the *Banking Act* of 1933, and the *Bank Holding Company Act* of 1956 (BHCA). The McFadden Act authorized a nationally chartered bank to branch only in the city where its main office was located and only if state-chartered banks were so permitted. The Banking Act of 1933 liberalized the branching authority of nationally chartered banks, allowing them to branch in each state to the same extent that state-chartered banks could. Each state thus could determine its own branching structure, and the state boundary was effectively established as the limit for bank branching.

Prior to passage of the BHCA, banks could acquire out-of-state banks through multibank holding companies. However, Section 3(d) of the BHCA, known as the Douglas Amendment, prohibited interstate bank acquisitions unless the state where the acquired bank was located specifically permitted such entry.[1] Until 1975, no state permitted such entry.

1. Under the BHCA's grandfathering provisions, there were 21 domestic bank holding companies that retained control over interstate banking subsidiaries.

Through an interstate ATM link-up, an individual can obtain cash, inquire about account balances, and transfer funds between accounts. Interstate ATMs cannot, however, accept deposits for out-of-state accounts.

A few very large banks are also positioning for interstate banking with *stakeout* investments. That is, these banks are purchasing significant equity interests in out-of-state banks by buying warrants for common stock or by acquiring nonvoting preferred stock that would convert to voting stock if geographic banking barriers were lifted.[3]

Public Policy Issues

A report prepared by the Carter administration examined whether the public would benefit if interstate banking barriers were lifted.[4] Issued in 1981, the report explored several strategies, including (1) relaxing current restrictions on the deployment of ATMs, (2) exempting banks' wholesale services from interstate restrictions, (3) repealing the Douglas Amendment, and (4) repealing the McFadden Act. Repealing the Douglas Amendment seemed the best alternative, for two reasons: it would be the least disruptive to public policy goals related to banking, and it would minimize federal intervention.

Five public policy issues were examined in the Carter report, as follows:

- Competition and the concentration of financial resources;
- Financial services to local communities;
- Viability of small banks;
- Soundness of the banking system; and
- The dual banking system, especially the division of authority between federal and state banking regulators.

The Carter report examined a large number of studies that, when coupled with other recent research efforts, provide a fairly comprehensive perspective on what results could be expected if geographic restrictions on banking were relaxed.

Concentration and Competition

Perhaps the most controversial issue in the interstate banking debate is the effect of fewer restrictions on competition among banks and the concentration of financial resources. At issue is whether interstate banking would foster better services, lower profits, and less concentrated banking resources.

On a national level, interstate banking would increase the concentration of commercial banking resources, reversing a trend toward less concentration. If interstate banking barriers were lifted, the nation's largest banks would be especially aggressive in entering new interstate markets; banks with strong market positions in metropolitan areas would undoubtedly be prime targets for acquisition.

Banking competition and concentration are especially important on the local market level, for it is here that individuals and small businesses are geographically limited in their choice of suppliers of financial services. Local markets are typically a county or a metropolitan area. If interstate banking barriers were removed, concentration in a local banking market would necessarily increase if a bank holding company acquired more than one bank in that particular market. Multiple acquisitions in a state likewise would increase statewide concentration, since competitors would be eliminated.

There is another concentration issue that is particularly relevant to the interstate banking debate—the effect of holding company affiliation on an acquired bank's market share. At issue here is whether a market's level of concentration is affected when a holding company acquires only one bank in that market. A recent study found that holding company affiliation increased the market share of small banks and reduced the market share of large banks.[5] But in both instances the deconcentrating effect on a market was very small. That is, holding company affiliation resulted in no greater concentration or, at most, limited deconcentration of deposits in local markets. Thus, although the

3. See "Bank Holding Companies and Change in Bank Control: Statement of Policy on Nonvoting Equity Investments by Bank Holding Companies," Board of Governors of the Federal Reserve Sytem, July 8, 1982.

4. See *Geographic Restrictions on Commercial Banking in the United States, The Report of the President*, Department of the Treasury, January 1981. Also see *Compendium of Issues Relating to Branching by Financial Institutions*, Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 94 Cong. 2 Sess. U.S. Government Printing Office, October 1976.

5. See John T. Rose, "Bank Holding Company Affiliation and Market Share Performance," *Journal of Monetary Economics*, vol. 9, no.1 (January 1982), pp.109–119.

removal of interstate banking barriers could not be expected to result in less concentrated local markets, neither could we expect that fewer interstate barriers would increase deposit concentration in local markets.

Evidence suggests that entry of bank holding companies into new markets on a *de novo* basis would result in a more competitive structure. A study by Rose and Savage found that rather sizable deconcentration resulted from *de novo* entry into rural and small metropolitan markets.[6] It would thus make sense to encourage interstate entry on a *de novo* basis. However, few banks would probably heed such encouragement since *de novo* entry rarely achieves effective market penetration.

Even if higher concentration levels resulted from lifting interstate banking barriers, the threat of potential entry would help ensure competitive behavior. To illustrate: although an aggressive bank might obtain a significant share of a market's deposits, its products would still have to be competitively priced.[7] Otherwise, the bank would be inviting additional competitors into the market. When the effects of potential entry and higher concentration levels are combined, the question becomes whether the positive effects of potential entry outweigh the negative effects of concentration.

The *linked oligopoly theory* has been applied to the banking industry to analyze the competitive effects of multimarket banking. According to this theory, as multimarket firms increasingly meet each other in geographically dispersed markets, less competition would occur; a firm's aggressive actions in one market might provoke retaliation by competitors in other markets where the firm may be more vulnerable. A recent study of banking in Florida casts doubt on some earlier studies, finding that competitive performance would not deteriorate as intermarket linkages multiplied.[8]

Service, Survival, and Soundness

Some analysts contend that local banking services would deteriorate as a result of interstate banking. Studies examining local financial services in states that authorized multi-office banking tend to dispute this contention. On the contrary, small communities in states that permit multi-office banking experienced improved banking services, including more liberal loan terms, higher deposit interest rates, and more loan extensions. While it is not known whether the larger credit volume was made to borrowers within local communities in which a bank had opened offices, no evidence showed that lenders had systematically transferred funds from banking offices in rural areas to those located in urban areas. States permitting multi-office banking also experienced an increase in the number of banking *offices*, though the number of banking *organizations* had declined. Such evidence generally suggests that local communities would receive better banking services if interstate banking restrictions were eased.

Interstate banking would reduce the number of banks. Small banks in particular contend that they would be overwhelmed by large banks. Several studies have examined the operations of small banks in states that allow intrastate expansion, either via branching or bank holding company acquisitions, and where large banks are dominant. In California, for example, banks with assets exceeding $100 million accounted for only 25 percent of the state's banks in 1977, but controlled 97 percent of statewide banking assets.[9] Yet, California's banks with assets between $10 million and $100 million were able to earn, on average, a return on assets about the same as the state's larger banks. When intrastate branching was authorized in New York State in the mid-1970s, large banks headquartered in New York City tried and failed to penetrate banking markets in upper New York State that were controlled primarily by small banks. In fact, many of the large banks' newly opened offices closed because of unprofitable operations or ineffective market penetration. These studies indicate that small banks *can* survive and compete with large banks in a geographically unrestricted banking environment.

Evidence that large banks have no cost advantages over smaller banks underscores the ability of small banks to thrive without geographic banking restrictions. In fact, studies on scale economies in banking show that the optimal bank size is relatively small, with deposits between $10 million and $25 million. This is consistent with the observation that a mixture of banks—large and small, unit and branch, independent and affiliated—today compete in many metropolitan markets.

Because the soundness of banks is the cornerstone of public policy toward banking, the effects of freer geographic restrictions on the solvency of banks deserve close attention. Loosening interstate banking restrictions would not necessarily increase the number of insolvent or problem banks. Most banks fail because of self-dealing, mismanagement, or embezzlement. Moreover, studies show that the percentage of insolvent or problem

6. See John T. Rose and Donald T. Savage, "Bank Holding Company De Novo Entry and Banking Market Deconcentration," *Journal of Bank Research*, vol. 13, no. 2 (Summer 1982), pp. 96–100.

7. See Timothy Hannan, "Bank Profitability and the Threat of Entry," *Journal of Bank Research*, vol. 14, no. 2 (Summer 1983), pp. 157–163.

8. See David D. Whitehead and Jan Luytjes, "Can Interstate Banking Increase Competitive Market Performance? An Empirical Test," *Economic Review*, Federal Reserve Bank of Atlanta, January 1984, pp. 4–10.

9. Data for California and New York banks were taken from *Geographic Restrictions on Commercial Banking in the United States*, p. 160.

banks in states with branching authority is only slightly higher than that in unit banking states.[10] Other evidence shows that multi-office banking and bank holding company affiliation are associated with an increase in bank riskiness as measured by such factors as a larger percentage of assets held as loans and lower capital-to-assets ratios.[11] Nevertheless, these higher risk levels did not seem to result in a larger number of closed or problem banks. In any case, these adverse effects are probably inconsequential when compared with an important benefit of interstate banking—facilitating the takeover of weak or insolvent banks.

In our dual banking system, state- and federally chartered banks currently operate in each of the 50 states. The dual banking system would be largely unaffected if interstate banking occurred through repeal of the Douglas Amendment. States would continue to regulate state-chartered interstate bank subsidiaries, and federal regulators would supervise those with federal charters. The repeal of the McFadden Act, however, to permit interstate *branching* would probably create some formidable problems. For example, jurisdiction over interstate branches of state-chartered banks would have to be allocated, and differences in state regulatory policies toward state-chartered banks would have to be resolved.

Conclusion

A growing number of states permit interstate banking, a trend that is pressuring federal legislators to relax interstate banking barriers. Evidence suggests that removing these barriers would encourage beneficial competition among banks. However, it is doubtful whether current antitrust laws are adequate to prevent the possible negative effects of geographically unrestricted banking. If antitrust laws were teamed with federal guidelines limiting the size of acquisitions, the adverse effects of higher concentration levels could be minimized, and consumers could benefit from the removal of interstate banking barriers.

10. See *Geographic Restrictions on Commercial Banking in the United States*, p. 120.

11. See *Geographic Restrictions*, p. 129.

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