In drafting regional reciprocal banking legislation, a state choosing to limit entry to bank holding companies from a specific region should consider the possibility of leapfrog entry. If an out-of-region bank holding company enters a state in the region, perhaps by acquiring a failing bank or because one state has more liberal entry laws, the bank holding company might then use that in-region foothold to enter other states in the group. To prevent such leapfrog entry, a state may have to limit entry to only those bank holding companies in the region that are principally owned in the region and that have their principal operations in the region. An anti-leapfrog provision becomes particularly important if a state elects to be included in more than one region. If Ohio, for example, were to choose the regional approach and also choose to be a member of two regions—say a Great Lakes region and mid-Atlantic region—Ohio’s partner states in each region would need to prohibit leapfrog entry through the common state.

Some federal and some state regional banking laws include nationwide triggers that name a date on which interstate banking restrictions would be removed. If congressionally mandated, such provisions could establish regional banking arrangements as transitional and ensure that any inequities resulting from regional banking pacts would be temporary. Nationwide triggers would also help to prevent the balkanization of the U.S. banking system—i.e., division of the nation into regions, each being dominated by a few large banks.

Conclusion
State and federal legislators, banking regulators, and the public are beginning to acknowledge the inevitability of interstate banking. At the moment, the states have taken the initiative in the interstate banking movement. Regional banking zones, despite their shortcomings, would move the banking industry further into today’s increasingly deregulated financial marketplace. However, since the most obvious advantage of regional banking is its ability to bridge the gap between single-state banking and nationwide banking, interstate banking pacts should not be an end in themselves.

Regional Interstate Banking
by Gerald H. Anderson, Thomas M. Buynak, and James J. Balazsy, Jr.

More and more, bankers and legislators are initiating state laws to lower legal barriers to interstate banking. Using the authority of the Douglas Amendment of the Bank Holding Company Act of 1956, states are opting for one of three kinds of entry for out-of-state bank holding companies to acquire banks within a state’s borders:
- Unrestricted entry. Any out-of-state bank holding company can own a bank in the state.
- Reciprocal entry. An out-of-state bank holding company can own a bank in the state only if the bank holding company’s home state permits reciprocal entry.
- Regional reciprocal entry. An out-of-state bank holding company can own a bank in a state only if the bank holding company is from a reciprocating state in a specified geographic area. Regional reciprocal entry, currently the most popular interstate banking arrangement, could have considerable impact on banking structure and on the economy.

Figure 1 Proposed Banking Regions

State Initiatives
In figure 1, we show three proposed U.S. banking regions. As of May 1984, New England was the only region of the United States that had established a regional reciprocal interstate banking pact. Massachusetts, in 1982, and Connecticut and Rhode Island, in 1983, enacted laws permitting reciprocal entry by bank holding companies from New England states only. Georgia’s legislature also has enacted a law that permits reciprocal entry from nine other southeastern states. Comparable bills have been passed in Florida and South Carolina, while a similar bill is pending in North Carolina. The Nebraska legislature is considering a bill to permit reciprocal entry from ten other states in that region. The Utah legislature passed a bill in March 1984 that will permit entry from 11 western states on a reciprocal basis. A Kentucky law, which will become effective in July of this year and is similar in structure to a bill pending in Ohio, allows reciprocal contiguous state entry for two years and then converts to national reciprocal entry.

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Address Correction Requested: Please send corrected mailing label to the Federal Reserve Bank of Cleveland, Research Department, 5305 Rockside Road, Cleveland, OH 44122.
The Effects of Regional Interstate Banking

Regional banking arrangements could provide a transition from regulated, single-state banking to a competitive, nationwide banking environment. According to proponents of regional banking, such pacts would benefit from a regional setup in a number of states; would be less attractive to the nation’s largest banks, as these institutions have deposits over $12 billion. Banks within a region would benefit from a regional setup if they were planning to acquire interstate bank interests, particularly because out-of-region banks, especially the aggressive money-center banks, would be excluded from bidding. However, if a bank within a region intended to be acquired, bank stockholders would forego the opportunity to receive more attractive bids from out-of-region banks. A regional structure does not serve the interests of out-of-region banks. A banking organization that has Edge Act offices, loan production offices, and bank holding companies in banks in states that have Edge Act offices would have a larger discriminatory effect on banking organizations that are excluded from regional interstate banks.

Regional arrangements might encourage open banking companies to channel a large percentage of their resources into nonbanking activities. This expansion would enable bank holding companies to establish a presence in states from which they may have been excluded. However, diminishing the importance of a bank’s presence in states from which it may have been excluded, than an unrestricted reciprocal or non-reciprocal arrangement. Proponents of regionalism argue that regional banking organizations would be more responsive to middle-market firms, small businesses, municipalities, and regional industries. Regional banks would have already developed expertise in lending to the region’s industries and would be more likely to accommodate small businesses than large banks. Even if a bank within a region were excluded from entering a region, it must identify which states would be included in the region. There are at least four criteria for selecting partner states:

1. Proximity. A state might choose contiguous states as partners, to include banking markets that extend into bordering states. However, the states on the periphery of a region might find this arrangement less attractive than those near the center, especially if some of the peripheral states’ natural markets were outside the region.

2. Natural structure. A regional interstate banking pact among states with similar industrial structures would enable banks to make use of their lending expertise near the center, especially if some of the peripheral states’ natural markets were outside the region.

3. Interest rate. The pace at which it changes.

4. Interstate banking. Of the 20 states that have statewide branching, 15 have language that would allow banks to expand into bordering states. However, the states on the periphery of a region might find this arrangement less attractive than those near the center, especially if some of the peripheral states’ natural markets were outside the region.

5. Intrastate banking. State banking laws determine whether a state allows multibank holding companies to influence the state’s banking structure—i.e., the size and number of banks in the state.

Legal Issues

Some critics contend that regional banking pacts violate provisions of the U.S. Constitution, one of which specifies that no state shall, without the consent of Congress, enter into any agreement or compact with another state. In 1984, a federal appeals court stayed two interstate mergers of Massachusetts and Connecticut banking organizations to study the issue of constitutionality. The Federal Reserve Board had approved the mergers, concluding that it would not “hold a state bank that unconstitutionally without clear and unequivocal evidence of the inconsistency of the state law with the U.S. Constitution.”

Several bills have been proposed to eliminate objections to interstate banking pacts made on the basis that they violate the compact clause of the U.S. Constitution. Senator Paul Tsongas and Representative Barney Frank of Massachusetts introduced bills (S.1002 and H.R.2431, respectively) that would give congressional approval to the New England interstate arrangement. Senator Jake Garn of Utah, chairman of the Senate Banking Committee, and Senator Mack Mattingly of Georgia have introduced bills (S.2181 and S.2113, respectively) that would permit states in any region to set up regional interstate banking areas. Senator Garn’s bill would authorize states to establish regional banking zones during a five-year period.

Other pending interstate banking legislation includes U.S. Senator Bernard’s H.R.5446, which would require federal regulators of banks and savings and loan associations to recognize any state law permitting out-of-state financial institutions to enter that state. In addition, Senator Alfonse D’Amato of New York proposed in S.2107 to phase out the Douglas Amendment over a five-year period, authorizing bank holding companies to acquire one additional bank in each of two states every year for five years. This bill stipulates that if a state forbids entry of out-of-state bank holding companies, its own bank holding companies may enter other states. D’Amato’s bill would remove all interstate restrictions on acquisitions by bank holding companies after the fifth year.


4. Evidence indicates small- and medium-sized businesses are most likely to use most of the dollar volume of bank loans to small businesses. Large banks provide only one-fourth of small business loans, but about two-thirds of total bank loans to large businesses, see Cynthia Glaseman and Peter L. Struck, “Survey of Commercial Banking Lending to Small Business,” Studies of Small Business Financing, Anti-Monopoly Task Force on Small Business Finance (January 1982), p. 7.


The Effects of Regional Interstate Banking

Regional banking arrangements could provide a transition from regulated, single-state banking to a competitive, nationwide banking environment. According to proponents of regional banking, such pacts would give banks within a specific region time to grow, increasing their ability to resist unfriendly takeovers and to compete with larger banks in a nationwide banking system. Proposed regions typically exclude New York, California, and Illinois—states that house the nation’s largest banks, which have assets over $12 trillion. Banks within a region would benefit from a regional setup even if they were planning to acquire interstate banks, because out-of-region banks, especially the aggressive money-center banks, would be excluded from bidding. However, if a bank within a region intended to be acquired, bank stockholders would forego the opportunity to receive more attractive bids from out-of-region banks.

A regional structure does not serve the interests of out-of-region banks. A banking organization that has Edge Act offices, loan production offices, and banking company nonbanking subsidiaries in a number of states would be less adversely affected by exclusion from regional zones. Citicorp, for example, currently operates 276 offices in 37 states. However, regional banking would have a larger discriminatory effect on banking organizations that are excluded from regional bank zones and that have few interstate offices.

Regional arrangements might encourage exclusive bank holding companies to channel a large percentage of their resources into nonbanking activities. This expansion would enable bank holding companies to compete aggressively for the presence in states from which they may have been excluded. However, diminishing the importance of a state’s banking presence would be more difficult and costly; money-center banks would probably rather attract new business from large corporations and strengthen their ties with local corporate customers.

Exclusion of the money-center banks from a region would not reduce the banking services available to small- and middle-market firms, since they do not currently offer a significantly wider array of financial products or services than the class of bank customers.

Consumers rely on local banks for the majority of their banking services, although technological advances, banking deregulation, and competition from nonbanking firms, such as Sears or Merrill Lynch, are eroding this dependence. Where local-market banking services are still limited and less competitive, lifting geographic banking barriers would have some pro-competitive effects. However, there is no reason to expect that regional banking would improve consumer services any more than restricted banking would. One disadvantage of state-initiated regional banking zones is that they could divide many natural banking markets. To illustrate, of the 282 standard metropolitan statistical areas in the United States, 26 extend across state lines. One major advantage of state-legislated interstate banking is that it allows states to shape their own intrastate banking structure and to determine the pace at which it changes.

Choosing Partners

If a state decides to institute regional interstate banking, it must identify which states will be included in the region. There are at least four criteria for choosing regional partners:

- Proximity. A state might choose all contiguous states as partners, to include banking markets that extend into bordering states. However, the states on the periphery of a region might find this arrangement less attractive, especially if some of the peripheral states’ natural markets were outside the region.
- Core Structure. A regional interstate banking pact among states with similar industrial structures would enable banks to make use of their lending expertise and influence near the center. Alternatively, a banking region that consists of states with contrasting economies would give banks the opportunity to develop more diversified loan portfolios and deposit bases.
- Intrastate banking. State banking laws determine whether a state allows multibank holding companies and influence a state’s banking structure—i.e., the size and number of banks in the state.
- Legal Issues

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7. See Federal Reserve Order, March 26, 1984, approving the merger of Bank of New England Corporation, Boston, MA, with CBT Corporation, Hartford, CT, p. 9.
In drafting regional reciprocal banking legislation, a state choosing to limit entry to bank holding companies from a specific region should consider the possibility of leapfrog entry. If an out-of-region bank holding company enters a state in the region, perhaps by acquiring a failing bank or because one state has more liberal entry laws, the bank holding company might then use that in-region foothold to enter other states in the group. To prevent such leapfrog entry, a state may have to limit entry to only those bank holding companies in the region that are principally owned in the region and that have their principal operations in the region. An anti-leapfrog provision becomes particularly important if a state elects to be included in more than one region. If Ohio, for example, were to choose the regional approach and also choose to be a member of two regions—say a Great Lakes region and mid-Atlantic region—Ohio’s partner states in each region would need to prohibit leapfrog entry through the common state.

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Regional reciprocal entry, currently the most popular interstate banking arrangement, could have considerable impact on banking structure and on the economy.

**State Initiatives**

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