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ECONOMIC COMMENTARY

Interstate Banking: Its Impact on Ohio Banks

by Thomas M. Buynak

Interstate banking is rapidly becoming a marketplace reality. The pace of change is so rapid that 1985 may be a watershed in eliminating interstate banking barriers. No state permitted interstate banking until 1975. Today, 27 states allow some type of out-of-state entry by commercial banks.

Recently, Ohio joined Kentucky and Indiana in permitting interstate banking. Ohio has adopted *regional reciprocal* interstate banking legislation. In this *Economic Commentary,* we examine the rationale for this approach, summarize the Ohio legislation, and look at the status of interstate banking legislation in those states included in the Ohio legislation.

It appears that a regional banking zone, as contemplated in Ohio's legislation, is forming in the Midwest. Thus, it is relevant to ask how a midwestern banking region would affect Ohio banks. By comparing the commercial banking structure in Ohio with several states included in Ohio's legislation, we can speculate about the possible effects of interstate banking on Ohio banks. Then, by examining the financial condition of Ohio's largest banking organizations, we can assess how well they are positioned to expand into markets beyond the state's borders.

The Popularity of Regional Interstate Banking

Because Congress has been unable to enact federal interstate banking legislation, the states have taken the initiative. Each state is authorized by the Douglas Amendment of the Bank Holding Company Act of 1956 to permit entry of out-of-state banks into its territory. Bank holding companies (BHCs) can thus cross state lines.

The 27 states authorizing interstate banking have taken a variety of approaches that are generally designed to benefit the state's economy and to protect and enhance the position of each state's banks and shareholders. Alaska, Arizona, and Maine, for example, have the most liberal laws, allowing unconditional out-of-state entry; New York allows entry from any state if that state reciprocates. Other states, such as Ohio, Kentucky, and Indiana, allow regional reciprocal interstate banking.

The *regional reciprocal pact,* which restricts entry to contiguous states or to states in a specified region, is the most popular approach; 15 states have adopted it.[1] Banking regions are forming in New England and in states in the mid-Atlantic area, the Far West, the Midwest, and the Southeast.

One objective of the regional approach is to unite states that have similiar economic structures. A more important objective, however, may be to protect local banks by selectively barring entry from certain states, such as New York, where the large, money-center banks are headquartered. While Ohio's largest BHC has approximately $9 billion in deposits, for example, New York has six banking organizations whose deposits each exceed $25 billion.

The protection of local banks in regional banking pacts, however, limits the number of potential bidders for banks that elect to become acquirees. From a seller's view, regional banking yields more bidders than the status quo — assuming a state permits BHC expansion on an intrastate basis, but there would be more potential bidders if interstate banking were completely unrestricted. This makes the terms of trade, or the acquisition premium paid over stock price, for the selling bank possibly less favorable than if nationwide banking were permitted.

Ohio's Interstate Banking Legislation

In March 1985, the Ohio House passed an interstate banking measure. By early July, in light of a U.S. Supreme Court ruling upholding the constitutionality of *selective* regional banking pacts, the Ohio Senate quickly enacted the House bill with two key amendments.[2] One amendment shortened the *trigger date* to nationwide banking from four years to three years.[3]

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1. See *Banking Expansion Reporter,* vol. 4, no. 17 (September 2, 1985), pp. 5-7.

2. On June 10, 1985, the U.S. Supreme Court reduced legal uncertainities surrounding the selective exclusion of states from regional reciprocal pacts. New England's interstate banking laws were contested, because New York banks were excluded from the New England banking region. New York banks argued that, according to the Douglas Amendment, a state's only choice in permitting interstate banking is an *all-or-nothing* proposition. The Supreme Court disagreed.

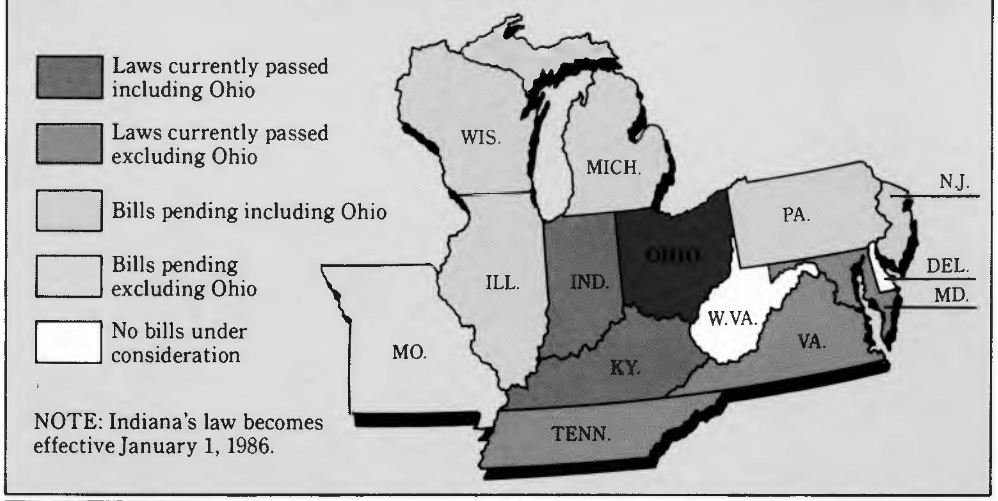
The other amendment added savings and loan institutions to the legislation.

Under Ohio's legislation, reciprocity is extended to commercial banks and to savings and loan institutions in Michigan, Indiana, Kentucky, West Virginia, Pennsylvania, Missouri, Wisconsin, Illinois, Tennessee, Virginia, Maryland, Delaware, New Jersey, and the District of Columbia. The law becomes effective October 17, 1985. It also provides that, after October 16, 1988, Ohio will grant reciprocal entry to any state on a nationwide basis.

A BHC entering Ohio must have its *principal place of business* (that is, 51 percent of its deposits) in an authorized reciprocating state. This prevents excluded banking organizations from entering Ohio through what is referred to as *leapfrogging.* To illustrate: assume that an out-of-state acquisition of an Ohio bank is legal initially (e.g., a Kentucky BHC acquires an Ohio bank). Now assume that the BHC is subsequently acquired itself by another BHC in an unauthorized state, say a New York BHC, because the state has an earlier trigger date (e.g., the Kentucky BHC is subsequently acquired by a New York BHC before Ohio's 1988 nationwide trigger). This would violate Ohio's law, which would require that the unauthorized New York BHC divest the Ohio bank.

When Ohio's legislation becomes effective in October 1985, Ohio banks will be able to merge with banks in Kentucky and Indiana, since both states have already enacted contiguous state reciprocal interstate banking laws that include Ohio (see map). Of the 11 other states included in Ohio's legislation, Tennessee, Virginia, and Maryland recently passed interstate banking laws, but none includes Ohio. Bills pending in Wisconsin, Michigan, New Jersey, Illinois, and Pennsylvania would extend reciprocity to Ohio. However, Ohio is excluded in bills pending or considered in Missouri and in the District of Columbia. Delaware is not currently considering interstate banking legislation.

Figure 1 Status of Interstate Banking Legislation: States Included in Ohio's Law



NOTE: Indiana's law becomes effective January 1, 1986.

In West Virginia, an outline of proposed legislation, which would extend reciprocity to Ohio, is currently circulating among members of West Virginia's Bankers Association.

In Pennsylvania, an interstate banking bill was pre-filed with the legislature on August 19, 1985, but passage this fall seems unlikely because no consensus exists among Pennsylvania bankers on the bill's provisions. In Michigan, an interstate banking bill was passed in 1984, but was vetoed by the governor. Its future passage, however, is virtually guaranteed if Michigan bankers agree to compromise on some consumer and usury issues.

Implications for Ohio Banks

Ever since Ohio legislators began discussing interstate banking, there has been speculation about whether or not the state's banks will grow and prosper as a result of interstate banking. Some bankers and communities are concerned that their banks will eventually be acquired by out-of-state banks.

The existence of interstate banking does not necessarily mean that all Ohio banks will be targets for acquisition. Under interstate banking, each Ohio bank can pursue one of three basic long-term strategies: attempt to be an acquirer, an acquiree, or position itself to remain independent.

Regardless of a bank's size, banking consultants believe that the key to success in an interstate banking environment is maximizing shareholder value.[4] The consultants offer two basic suggestions to achieve this: (1) a bank should excel at basic banking, focusing on achieving a high net interest margin — that is, the difference between interest earned and interest paid, and (2) the bank should work to hold a loyal customer base. This strategy might enable the bank to build enough strength to remain independent. Pursuing such a strategy, a bank would be in a good position to buy weaker banks, inasmuch as this action would have little impact on the earnings of stockholders. Also, the bank could choose to merge with a strong bank among its peers, or its stockholders could elect to sell out and to reap the rewards of their higher shareholder value.

3. According to the Federal Reserve, a federal law should mandate that regional banking pacts have a three-year *trigger,* which would convert them to nationwide reciprocity. Some bankers strongly oppose nationwide triggers and would like to permanently bar the money-center banks.

4. See Edward E. Furash, "Preparing for Interstate Banking: Maximizing a Bank's Value," *Economic Review,* Federal Reserve Bank of Atlanta, January 1985, pp. 6-11.

5. See John Danforth, "An Overview of Acquirers' Strategic Choices," pp. 12-15; Jon Burke, "Strategies for Potential Acquirees," pp. 16-20; and David C. Cates, "Prices Paid for Banks," pp. 36-41, *Economic Review,* Federal Reserve Bank of Atlanta, January 1985.

Table 1 Ohio Bank Holding Company Acquisitions of Large Intrastate Banking Organizations
Since 1980

		Deposit ranking		
Year	Banking organizations	Before acquisition[a]	After acquisition[b]	Deposits, March 1985[c]
1982	National City Corporation Ohio Citizens Bancorp., Inc.	4th 16th	1st	$8.8
	Huntington Bancshares, Inc. Union Commerce Corporation	6th 11th	5th	4.1
1983	Banc One Corporation Winters National Corporation	3rd 11th	2nd	7.6
1984	Society Corporation Interstate Financial Corp.	6th 15th	3rd	7.0
	National City Corporation BancOhio Corporation	4th 2nd	1st	8.8
1985	Society Corporation Centran Corporation	4th 7th	3rd	7.0

a. Rankings are as of date prior to acquisition.
b. Rankings are based on March 1985 deposit size.
c. Billions of dollars.

Interstate banking strategies. Several strategies are open to Ohio BHCs that are interested in interstate operations.[5] For Ohio's larger BHCs, the regional banking pact would give them three years to accumulate additional assets and to achieve what many banking analysts refer to as *critical size.* A large asset size, say over $15 billion, would make it more expensive for out-of-state money-center banks to purchase Ohio's larger BHCs. Research findings have yet to pinpoint the minimum size necessary to stave off most acquisitions. Thus, the concept of critical size is more heuristic than concrete.

In a recent study by the Federal Reserve Bank of New York, it was observed that the financial costs of absorbing a major bank acquistion would become severe when the acquiree bank is at least 20 percent as large as the acquirer bank, and the purchase premium approaches 50 percent.[6] Regional banks, with high capital ratios and strong earnings performance, are attractive to potential acquirers. However, these same financial characteristics make regional banks more costly to acquire. Regional banks become even more expensive acquisitions if they accumulate additional assets and remain strong, highly capitalized performers.

Since 1982, Ohio's largest BHCs have been accumulating critical size through a number of *intrastate* mergers (see table 1). If Ohio's largest banks continue to grow, they will be in a better competitive position when nationwide banking arrives.

Interstate banking would also benefit Ohio BHCs by allowing them to consolidate operations after an acquisition, thus reducing data processing, operations, product development, and marketing costs. It is uncertain to what extent cost reductions could be realized, because economic studies show that large size is not required to become an efficient producer of banking services.[7] As interstate acquirers, Ohio BHCs could diversify their deposit base as well as the mixture of their assets.[8]

Recently, money-center banks have suffered high loan losses, and higher regulatory capital standards have been imposed on them, forcing them to reduce lending, which adversely affects their earnings. Our financial analysis of Ohio banks shows that Ohio's largest BHCs are highly capitalized, which explains why they are particularly attractive to money-center banks. Ohio banks also hold another valuable commodity that makes them attractive acquirees. As banking becomes deregulated, banks pay market interest rates on the bulk of their deposits, which ironically now represents their *core* deposit base. Like their counterparts elsewhere, Ohio banks pay market rates on most of their deposits; however, they also typically have a less volatile deposit base, and some continue to reap lower costs because of a larger-than-typical level of low-rate, rate-ceiling deposits.[9]

Banking structure in Ohio and selected states. According to the recent status of interstate banking legislation, seven states have legislation or bills pending that would include Ohio on a reciprocal basis. Ohio is included in legislation enacted by Kentucky and Indiana and would be extended reciprocity in bills pending in Michigan, Pennsylvania, Wisconsin, New Jersey, and Illinois. Table 2 examines several aspects of these states' commercial banking structures. This allows us to infer about possible implications of interstate banking for Ohio banks strictly from a *structure* perspective.

Currently, Ohio has total commercial banking deposits of approximately $56 billion; it ranks seventh nationwide in size of deposits. As of year-end 1984, Ohio had 239 banking organizations after consolidating the banking subsidiaries of BHCs. There are 66 BHCs operating in Ohio with control over $49 billion in deposits, representing 87 percent of statewide commercial bank deposits. Fifty-one of Ohio's BHCs have deposits of less than

6. See Leon Korobow and George Budzeika, "Financial Limits on Interstate Bank Expansion," *Quarterly Review,* Federal Reserve Bank of New York, vol. 10, no. 2 (Summer 1985), pp. 13-27. This study finds that, because of the costs involved in acquiring regional banks, interstate acquisitions would be self-limiting. As a result, money-center banks would have to be selective in their interstate acquisitions.

7. These economic studies, which found cost reductions at a low output level, were conducted when banking was highly regulated. It is not clear how a deregulated, more technological environment has affected bank cost.

8. There is disagreement about whether regional banking is superior to the status quo or to a nationwide banking system. For a comparison of regionalism with other major alternatives, see Donald T. Savage, "The Alternative of Regional Interstate Banking," *Issues in Bank Regulation,* Autumn 1984, pp. 3-10. Savage concludes that regional banking is not likely to produce significant efficiencies for consumers or for banks. He argues further that regionalism would

$500 million; all except six of them are one-bank (unitary) BHCs. Ohio has eight banking organizations whose deposits exceed $2 billion, and five whose deposits exceed $4 billion. The state's three largest banking organizations control, on average, about $7 billion in deposits. Ohio's three largest banking organizations control 38 percent of statewide commercial banking deposits, thus classifying the state's banking structure as moderately concentrated.

When compared to banks in Indiana and Kentucky, Ohio banks obviously have a formidable size advantage. Ohio's largest institutions are four times larger than the largest banks in Indiana and Kentucky. While their smaller deposit base partly explains their relatively smaller deposit size, until very recently, Indiana and Kentucky had more restrictive *intra*state banking laws, which also accounts for the disparity. Consequently, in contrast to Ohio, banking structure in these states is unconcentrated — both in an absolute and relative sense.

Among those five states whose interstate banking bills would extend reciprocity to Ohio, Ohio banks would retain a size advantage, or would at least maintain size parity, with banks in Michigan, Wisconsin, and New Jersey. When compared to Ohio, Michigan has fewer total deposits but has slightly larger institutions. It also has fewer banks and is slightly more concentrated. Although banking in New Jersey is as concentrated as in Ohio, its deposit base is below Ohio's, and there are fewer organizations with a smaller average deposit size. Wisconsin's banking structure essentially falls between the structures of Indiana and Kentucky.

Banks in Pennsylvania and Illinois currently have a size advantage over banks in Ohio. While deposits in these states are less concentrated than in Ohio, Pennsylvania and Illinois banks have a larger deposit base and have larger banks.

Table 2 Commercial Banking Structure in Selected States
As of December 31, 1984

				Average deposit size		
State[a]	Total commercial bank deposits[b]	Nationwide deposit ranking	Number of banking organizations	Three largest banking organizations[b]	Ten largest banking organizations[b]	Three-firm concentration ratio
Ohio	$56.1	7	239	$7.1	$4.0	38%
Indiana	35.3	12	375	2.1	1.1	18
Kentucky	22.3	23	329	1.9	0.8	26
Michigan	53.5	8	194	7.3	3.8	41
Pennsylvania	86.8	5	308	10.1	5.0	35
Wisconsin	29.3	17	440	2.9	1.3	30
New Jersey	44.3	9	96	5.8	2.9	39
Illinois	100.3	4	1,093	9.0	3.7	27
New York	309.1	1	326	27.8	16.1	27

a. All of these states, except New York, are included in Ohio's legislation, and they have passed or are considering interstate banking legislation that would include Ohio.
b. Billions of dollars.

Although Illinois has a larger deposit base and two large banks with combined deposits of $44 billion, Pennsylvania banks are more likely to pose a takeover threat to Ohio banks. Illinois has only four banks whose deposit size exceeds $2 billion; Pennsylvania has 10 banks whose deposits exceed $2 billion.

Financial condition of Ohio's largest BHCs. By examining the balance sheets of Ohio's 15 largest BHCs, we can assess their potential as interstate acquirers.[10] Because of different, size-oriented financial ratios, the 15 BHCs are divided into two peer groups. Seven Ohio BHCs fall into one group with consolidated assets exceeding $3 billion. The eight other Ohio BHCs have assets from $500 million to $3 billion. By examining key financial ratios and comparing the Ohio BHCs by peer group with their BHC counterparts nationwide, we can characterize their general financial health. However, no inferences are drawn about *any single* BHC's financial capability as an acquirer, because the diversity of their respective operations makes it difficult to set broad guidelines for measuring their financial ability to acquire other banking organizations.

Return on assets (ROA) is the crucial financial factor in a BHC's performance. ROA, defined as the ratio of income to assets, is an indicator of how well a bank is using its assets. As defined earlier, a second profitability measure, net interest income, measures the margin of interest earned over interest paid by a bank.

When compared to their BHC counterparts, Ohio's largest banks were more profitable in 1984 and essentially matched the net interest margin of their peers (see table 3). The positive ROA gap between Ohio BHCs and their peers was substantial, particularly for smaller Ohio BHCs.

We continue the analysis by examining the level of capital relative to the BHCs' volume of operations. Capital, in effect, is a cushion against unforseen financial losses and, as such, represents a constraint on how much a bank's operations can be leveraged. Banking regulators recently tightened capital standards for banks. As

reduce the number of candidates attractive to acquirers in a nationwide banking environment and would lead to higher concentration.

9. One measure of deposit base stability is a liquidity ratio called *volatile liability dependence*, which shows what percentage of a bank's loans and investments are funded by volatile liabilities, such as large time deposits, foreign deposits, and commercial paper. For Ohio's 15 largest BHCs, this ratio was, on average, only one-half the ratio of their peer BHCs, as of year-end 1984.

10. In evaluating the merits of a BHC acquisition, the Federal Reserve assesses financial factors and looks at management, the acquisition's effect on banking competition, and the impact of the acquisition on the acquired bank's community.

Table 3 Selected Financial Ratios for Ohio's Largest Banking Organizations and Nationwide Peers[a]
As of December 31, 1984

	BHCs with assets greater than $3 billion[b]		BHCs with assets from $500 million to $3 billion[c]	
Financial ratios	**Ohio BHCs**	**BHC peers**	**Ohio BHCs**	**BHC peers**
Profitability and earnings				
Return on average assets	1.04	0.76	1.19	0.76
Net interest income	4.77	4.77	4.94	5.13
Capitalization				
Primary capital/total assets	7.52	6.69	9.08	7.22
Retained earnings/average equity	10.10	7.76	8.77	7.66
Growth rates				
Assets	17.23[d]	11.37	9.58	16.05
Primary capital	18.01[d]	11.03	10.63	16.61
Leverage (parent company)				
Total debt/equity	19.15	49.25	5.11	30.48
Long-term debt/equity	12.56	22.46	4.48	17.68
Loan loss analysis				
Net loan losses/average total loans	0.45	0.57	0.50	0.60
Allowances for loan losses/total loans	1.24	1.32	1.19	1.21

a. Ratios are *averages* for Ohio BHCs in each peer group and for BHC counterparts nationwide.
b. Ratios in this BHC peer category are the weighted average of two BHC peer classifications: those with assets exceeding $10 billion and those with assets between $3 billion and $10 billion. To compute the average ratio for nationwide BHC peers, the two peer ratios were weighted according to the number of Ohio BHCs in each peer classification.
c. Ratios in this BHC peer category are the weighted average of BHCs with assets between $500 million and $1 billion, and between $1 billion and $3 billion.
d. Growth rates exclude BHC acquisitions in 1984.
SOURCE: Bank Holding Company Performance Reports, December 31, 1984, Board of Governors of the Federal Reserve System.

discussed earlier, higher capital standards have primarily affected the nation's largest banks.

Some regulators are now proposing even stiffer capital standards for banks. Under one proposal, capital levels would be raised from 5.5 percent to as high as 9 percent. Another proposal would apply risk-based capital rules to banks that make riskier investments. (All banks now maintain the same level of capital, regardless of the nature of their activities.) It is not clear whether these proposals would affect larger banks more than smaller banks. If implemented, tighter capital standards would not only slow the growth of the banking system, but also would slow the pace of interstate banking.

Because Ohio banks are relatively more highly capitalized than banks of similar size throughout the country, they would be less affected by higher capital standards. Similarly, if risk-based capital rules were implemented, Ohio banks would be largely unaffected, because they have generally avoided high-risk investments.

As BHCs grow, the rate at which they generate capital internally affects how rapidly they can expand externally and avoid further leveraging of operations and lowering of capital ratios. Thus, we look at the ratio of retained earnings to equity as an indicator of the speed at which the Ohio BHCs can add assets without additional leveraging. We also look at growth rates for assets and capital and examine two ratios that measure how much the Ohio BHCs' *parent companies* rely on debt in their capital structure.

According to our analysis, both Ohio BHC groups are much better capitalized relative to their peer BHCs. Although there is an expected inverse relationship between the asset size of the Ohio BHCs and capital adequacy, the Ohio BHCs' capital adequacy relative to that of their peers improves as size decreases. This means that Ohio's smaller BHCs are more highly capitalized than the larger BHCs, after adjusting for size differences. Both Ohio BHC groups had relatively higher ratios of retained earnings to equity, especially the larger BHCs.

In 1984, the larger Ohio BHCs had a relatively higher growth rate of capital and assets. Their performance, however, is atypical of the BHCs' performance *on average* since 1980.[11] For smaller Ohio BHCs, the growth rates of assets and capital in 1984 were substantially below peer BHCs. Lower relative asset growth by Ohio banks is undoubtedly linked to the state's slow economic recovery. In the 1981-82 recession, Ohio's economy suffered a deeper decline than the nation as a whole, and Ohio's recovery has been lagging the nation's.[12] Also, it is readily apparent that both Ohio BHC groups are much less indebted than their peers.

Finally, we examine the loan loss experience of Ohio BHCs. High loan losses not only would impair earnings performance, but could affect the rate of internal capital generation. If a BHC has high loan losses, it would have to rebuild its loan loss reserves, which are considered a part of capital. In this circumstance, unless a BHC slows its rate of asset growth, high loan losses would put more pressure on its earnings.

The analysis shows that the Ohio BHCs had lower loan losses; this reflects Ohio bankers' more conservative banking philosophy, which has resulted in a history of strong credit quality. In fact, Ohio's largest banks have resisted an industry trend toward riskier investments. They have avoided becoming embroiled in nonperforming energy and farm loan problems and lending problems that involve developing countries.

11. Since 1980, the larger BHCs experienced asset and capital growth rates on average about 3 percent below their peers. The smaller BHCs had a five-year average asset growth rate 3 percent below peers, while their average capital growth rate was more than 4 percent below that of peers.

12. Non-agricultural employment, one measure of economic performance, declined only 0.9 percent nationally from 1980 to 1982, but fell 5.6 percent in Ohio during the same time period. Employment rose nationally 5.4 percent between 1982 and 1984, but grew only 5.4 percent in Ohio during those two years.

Concluding Remarks

Interstate banking should not threaten the independence of Ohio's large banks. Ohio banks have an opportunity to be a viable part of midwestern banking and eventually of a nationwide banking system as well. Despite banking deregulation, new banking technologies, higher capital standards, and a sluggish midwestern economic recovery, Ohio's largest banks are favorably positioned to enter interstate markets.

If Ohio's larger banks make prudent strategic choices before the state's 1988 nationwide trigger — that is, if they grow and maintain strength — then they can look forward to aggressively entering out-of-state markets, rather than defending themselves from takeovers by out-of-state banks.

Currently, a *window of opportunity* exists for Ohio BHCs, because they have a size advantage in the Midwest. However, this advantage will disappear in the next year or so, when states such as Pennsylvania and Illinois enact interstate banking legislation.

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