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# FRBSF WEEKLY LETTER

July 19, 1985

## The Joy of Interstate Banking: I

Public policy in this country over the last fifty or so years has opposed a nationwide interstate banking structure—at least in principle. Both the McFadden Act of 1927 and the Douglas Amendment to the Bank Holding Company Act represent fairly clear statements of Congress' opposition to full-service nationwide banking. However, efforts to circumvent the intent of this policy have been numerous, and market pressures have achieved substantial accommodation. Large banking organizations now conduct a wide range of banking activities across state lines through their non-bank subsidiaries.

The only restrictions on interstate banking that appear still to be binding are those on interstate branching and deposit-taking. But as even these restrictions begin to crumble, legislators are being forced to reconsider their policies toward the interstate activities of banks. Two developments, in particular, are generating much debate. First, the Supreme Court in June upheld the constitutionality of a New England regional interstate banking agreement at a time when similar regional interstate banking legislation is being enacted in a number of other states. Second, "nonbank" banks, which skirt restrictions on interstate branching by not being banks in a technical sense (i.e., they do not offer *both* demand deposits and commercial loans), are currently being chartered in a number of states.

This *Letter* discusses the regional (state) legislation affecting interstate banking. A follow-up *Letter* will discuss the actors and the nonbank bank and other issues affecting the move toward full-service, nationwide interstate banking.

### The future has almost arrived

Interstate banking already exists to a considerable extent. Some 7600 offices of out-of-state banking and savings and loan (S&L) organizations currently grace the Republic, providing interstate banking services through consumer and mortgage finance companies, loan production offices, Edge Act Corporations and grandfathered multi-state banking offices. Moreover, a plethora of banking services currently are provided across state lines without a bank office. These include credit cards,

nondeposit services through automated teller machines (ATMs) not owned but leased and shared by banks, and the solicitation of business (including deposits) through advertising as well as by mail and toll-free telephone lines.

Moreover, brokerage firms, which technically are barred from engaging in the business of banking, have been able to provide deposit-like services across state lines through money market mutual funds. Since the funds technically are shares rather than deposits (although they are equal in volume to 60 percent of the checking deposit component of M1), they are not subject to the "no mixing of banking and commerce" constraint of Sec. 21 of the Glass-Steagall Act. Nor do any of the constraints of Glass-Steagall, the McFadden Act or the Bank Holding Company Act apply to thrifts, which increasingly have assumed the character of commercial banks.

Finally, some 276 "nonbank banks" have been tentatively approved by the Comptroller (only about 14 are in operation, including entities owned by J.C. Penney, Merrill Lynch, Gulf and Western, and Parker Pen Company), and another 106 applications have been submitted, many of them by large bank holding companies. Because nonbank banks offer a full range of services other than *both* demand deposits and commercial loans, they are not technically banks and therefore none of the restrictions against interstate banking or against combinations of banking and commerce applies.

### State banking legislation

While national banking legislation prohibits nationwide banking, it does permit states to enact legislation of their own to allow out-of-state banking organizations to enter their boundaries. This provision, known as the Douglas Amendment to the Bank Holding Company Act, allows a bank or bank holding company to acquire a bank subsidiary in another state *if* the laws of the latter state specifically allow such acquisition. The Douglas Amendment has been interpreted by the states as a specific delegation by the Congress to the states of authority to regulate this form of interstate commerce. Senator Douglas himself said that

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his amendment "would leave the way open for states to make explicit provisions for interstate purchases and acquisitions (of banks) if they so decided."

Currently, twenty-five states have enacted or are considering interstate banking legislation under the Douglas Amendment. The forms of this state legislation run the gamut from allowing nationwide to allowing regional banking, entry by establishing new banks ("de novo") to entry only by buying existing banks, and reciprocal to non-reciprocal entry. Reciprocity refers to whether the state from which a banking organization is branching also allows entry by banking organizations from the destination-state. Alaska and Maine want to allow nationwide non-reciprocal entry through the acquisition of existing banks, whereas New York wants nationwide reciprocal entry through new or acquired banks. Other states want various selective regional compacts.

Besides Alaska, several other western states now have interstate banking provisions. Oregon's recently enacted legislation is regional in focus in that it will allow (as of July 1987) banks in any state in the Twelfth Federal Reserve District to acquire an Oregon bank that is at least three years old, but will not permit entry *de novo* and does not require reciprocity. Oregon's law also provides that in the event that the Supreme Court ruled against regional compacts (which the Court did not do in its recent decision), or if Congress were to enact legislation authorizing nationwide banking for national and state member banks, its interstate banking law automatically would become national rather than regional in its application.

Utah allows entry by acquisition on a reciprocal basis with eleven western states not including California, while Idaho's recently adopted law provides for reciprocity with contiguous states (but not entry by "leap-frogging"). Washington's legislation will allow entry through acquisition of banks at least three years old by any out-of-state bank or bank holding company regardless of location, but only on a reciprocal basis. Non-reciprocal legislation passed in Arizona will allow entry through merger or acquisition by any out-of-state bank in 1986, and entry *de novo* in 1992.

Finally, California is considering various proposals, including one embracing nationwide reciprocity. The California Bankers Association

favors an initial regional approach similar to Oregon's, but most large banks in the Association apparently believe that there is little to be gained by regional or reciprocal arrangements and consequently favor nationwide interstate banking. The spokesman for one large bank recently stated: "There are not many reciprocal markets (in the West) that really turn us on."

## Legalities

The growing popularity of these regional banking compacts was the subject of an important legal challenge mounted by Northeast Bancorp, Inc. and Citicorp. They challenged the constitutionality of legislation in Massachusetts and Connecticut that permitted New England-based bank holding companies, but not those from New York or other states outside the region, to acquire local banks. By selectively denying entry from some states, such legislation has the effect of denying interstate banking by the nation's largest banking organizations. The legal opposition was based on the overall argument that states cannot choose to allow entry by banking organizations from some states and not others. In other words, that the Douglas Amendment authorizes only an all-or-nothing approach.

In addition, Northeast Bancorp Inc. and Citicorp claimed that selective interstate banking violated the Equal Protection Clause of the U.S. Constitution. They also argued that interstate agreements amount to compacts that infringe on the sovereignty of federal and other state governments in violation of the Compact Clause, which stipulates that "no state shall, without the consent of the Congress...enter into any agreement or compact with another state..." Finally, they claimed that regional compacts violated the Commerce Clause of the Constitution by impeding the free flow of trade among states.

On June 10, the Supreme Court unanimously upheld the validity of the New England agreement. The Court stated that the Douglas Amendment did not limit states to an all-or-nothing choice, but gave them flexibility in controlling interstate banking. Moreover, it stressed that the legislative history of the Douglas Amendment gave ample indication of Congress' intent to retain local, community-based control over banking.

On the basis of these findings, the Court wrote that the New England agreement did not violate the

Equal Protection Clause because Congress had demonstrated that banking is of "profound local concern." It stated that the regional agreement was not a compact because there was not joint organization to regulate banking. Finally, the Court found that "When Congress so chooses, state actions which it plainly authorizes are invulnerable to constitutional attack under the Commerce Clause."

### **The issue of concentration**

The legal arguments for and against regional interstate banking are symptoms of major economic and political tussles. Specifically, there is considerable controversy over the effects of interstate banking on the concentration of market and political power. In the five years from 1978 through 1983, the share of domestic bank assets controlled by the top 100 banking organizations increased from 49 to 54 percent.

In late April, Federal Reserve Chairman Volcker testified before the House Banking Committee on interstate banking and his concern over excessive concentration. He recommended that acquisitions between the 25 largest banks be prohibited, that no bank be allowed to accumulate more than 15-20 percent of the banking assets in other than its home state, and that an upper limit (unspecified) be placed on any one bank's share of banking assets nationally. Similar provisions are in Congressman St Germain's (D-RI), "Depository Institutions Acquisition Act" (HR 2707).

Despite these kinds of restrictions on the interstate expansion of large banking organizations, interstate banking per se probably will increase the competition faced by small, local banks and almost certainly reduce the overall number of banks. Nonetheless, a well-run community bank taking full advantage of franchise and vendor services and its local roots will most likely survive and prosper, as they have in the shadow of giants in California. Some are concerned that even the out-of-state competition presented by large money center banks may encourage regional banks to merge to compete effectively, but there is no solid evidence to suggest that economies of scale exist in banking beyond a relatively small size.

### **Impact of Supreme Court decision.**

It may be too soon to gauge the precise impact of the Supreme Court's approval of selective regional interstate banking on federal interstate banking legislation. However, one can conclude that it has

stolen some fire from national legislative attempts and that it clearly has shifted the emphasis of interstate banking legislation to regional arrangements. Future national legislation, if any, probably would evolve from the regional model.

Many of the interstate banking bills now pending before Congress already approach nationwide banking from this perspective. Congressman St Germain's bill, for example, initially allows "certain interstate acquisitions of depository institutions," but also provides a "trigger" to require all states that enter reciprocal compacts at least two years before July 1990 to open their doors to all banks by 1990. However, opposition to any form of national "trigger" is strong.

A proposal of the Association of Bank Holding Companies (BHCs), which generally represents the large banks, also would open the way to nationwide banking. It would do this by first permitting BHCs, after two years, to acquire a bank in any contiguous state within the Federal Reserve District of the acquiring entity, and then by repealing the Douglas Amendment within four years.

Chairman Volcker also has recommended the adoption of federal legislation endorsing regional banking compacts on an "interim basis," with a specific "trigger" that would require that after three years, banks located in a state that is a member of one regional compact be allowed to acquire banks in states that are part of another regional compact. At the same time, and out of deference to "states' rights," he argued that federal legislation should recognize the right of any state to opt out of interstate banking by not entering into a regional compact. In this respect, his proposal differs from Congressman St Germain's. As a transitional, or perhaps minimum, step to interstate banking, he also suggested that branching be authorized within the 35 metropolitan areas (natural and contiguous markets) and extend across state lines.

### **Conclusion**

Regional interstate banking initiated on the state level is likely to have a lasting impact on the structure of the banking industry. But how quickly full interstate banking on the national level comes about is still very much open to question. Next week's *Letter* addresses some of the political issues that remain to be resolved before full interstate banking will become a reality. **Verle B. Johnston**

Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

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**BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT**

(Dollar amounts in millions)

| <b>Selected Assets and Liabilities<br/>Large Commercial Banks</b> | <b>Amount<br/>Outstanding<br/>7/03/85</b> | <b>Change<br/>from<br/>6/26/85</b> | <b>Change from 7/04/84<br/>Dollar</b> | <b>Percent<sup>7</sup></b> |
|---|---|------------------------------------|---------------------------------------|----------------------------|
| Loans, Leases and Investments <sup>1 2</sup>                      | 193,186                                   | 1,435                              | 10,198                                | 5.5                        |
| Loans and Leases <sup>1 6</sup>                                   | 174,423                                   | 1,059                              | 10,596                                | 6.4                        |
| Commercial and Industrial   | 51,511                                    | — 273                              | 1,119                                 | 2.2                        |
| Real estate   | 63,391                                    | — 31                               | 2,819                                 | 4.6                        |
| Loans to Individuals  | 34,780                                    | 238                                | 6,209                                 | 21.7                       |
| Leases  | 5,396                                     | 16                                 | 358                                   | 7.1                        |
| U.S. Treasury and Agency Securities <sup>2</sup>                  | 11,957                                    | 498                                | — 206                                 | — 1.6                      |
| Other Securities <sup>2</sup>                                     | 6,807                                     | — 121                              | — 190                                 | — 2.7                      |
| Total Deposits  | 201,794                                   | 6,644                              | 7,610                                 | 3.9                        |
| Demand Deposits   | 50,643                                    | 5,337                              | 537                                   | 1.0                        |
| Demand Deposits Adjusted <sup>3</sup>                             | 31,395                                    | 1,701                              | 2,510                                 | 8.6                        |
| Other Transaction Balances <sup>4</sup>                           | 14,188                                    | 1,054                              | 1,393                                 | 10.8                       |
| Total Non-Transaction Balances <sup>6</sup>                       | 136,962                                   | 252                                | 5,678                                 | 4.3                        |
| Money Market Deposit<br>Accounts—Total                            | 44,655                                    | 437                                | 6,030                                 | 15.6                       |
| Time Deposits in Amounts of<br>\$100,000 or more                  | 37,981                                    | — 418                              | — 1,504                               | — 3.8                      |
| Other Liabilities for Borrowed Money <sup>5</sup>                 | 22,717                                    | 328                                | 2,363                                 | 11.6                       |
| <b>Two Week Averages<br/>of Daily Figures</b>                     | <b>Period ended<br/>6/01/85</b>           | <b>Period ended<br/>6/17/85</b>    |                                       |                            |
| <b>Reserve Position, All Reporting Banks</b>                      |   |                                    |                                       |                            |
| Excess Reserves (+)/Deficiency (—)                                | 21  | 76                                 |                                       |                            |
| Borrowings  | 91  | 11                                 |                                       |                            |
| Net free reserves (+)/Net borrowed(—)                             | — 69                                      | 65                                 |                                       |                            |

<sup>1</sup> Includes loss reserves, unearned income, excludes interbank loans

<sup>2</sup> Excludes trading account securities

<sup>3</sup> Excludes U.S. government and depository institution deposits and cash items

<sup>4</sup> ATS, NOW, Super NOW and savings accounts with telephone transfers

<sup>5</sup> Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

<sup>6</sup> Includes items not shown separately

<sup>7</sup> Annualized percent change