FRBSF Weekly Letter

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The Joy of Interstate Banking: II

Last week's *Letter* provided an overview of the current dimensions and nature of interstate banking, including legislation designed to facilitate its development at the regional level. As that *Letter* pointed out, interstate banking already exists in the form of nonbank organizations that provide banking services on a nationwide basis. Whether banks *per se* will be allowed to conduct business on a nationwide basis, however, depends on the resolution of several thorny and related policy issues. These include "nonbank banks," expansion of asset and liability powers for banks, deposit insurance reform, and regulatory restructuring. This *Letter* reviews these issues and developments that may variously act as catalysts or obstacles in influencing the pace of the move towards interstate banking legislation on the national level.

Views from Capitol Hill

One of the issues that some members of Congress insist must be addressed in conjunction with any discussion of interstate banking is the nonbank bank movement. This movement presents a particularly difficult policy problem because many nonbank banks are not owned by banking organizations and therefore run counter to the long held view that banking and commerce ought to be separate. Moreover, since nonbank banks do not offer both demand deposits and commercial loans, they are not banks in the technical sense and are able to skirt restrictions on interstate branching directed at banks. In response, legislation has been passed by the House Banking Committee (Chairman St Germain's HR 20, the "Financial Institutions Equity Act") or will be re-introduced in the Senate to plug the nonbank loophole by broadening the definition of a bank to include any institution insured by the FDIC.

Completely plugging the nonbank bank loophole, however, may prove difficult. A number of large commercial banks already view nonbank banks as a means of extending their operations across state lines. A while back, Senate Banking Committee Staff Director Danny Wall commented that "as every day goes by there is more and more opposition to closing the loopholes," and especially to imposing the July 1, 1983 grandfathering date. Both the Chairmen of the House and Senate Banking Committees had originally insisted upon that date. Even now, HR 20 sets a grandfathering date at May 9, 1984 for nonbank banks established prior to that date.

Federal Reserve Board Chairman Volcker recently noted that savings banks and unitary S&Ls should not be excluded in any amendments to banking legislation because that would leave a potential loophole for nonbank banking through the acquisition of such thrifts by commercial and industrial entities. HR 20 addresses this consideration by exempting only "qualified" thrifts—those that have 65 percent of their assets in residential mortgages and related investments. The Independent Bankers have also pointed out that nonbank banks may be acquired through state charter, as Sears did in Delaware. To date, only some seven states have passed legislation specifically *prohibiting* nonbank banks.

Recently, there has been renewed interest in authorizing so-called "consumer banks." The Chairman of Sears Roebuck, in asking for Congressional authorization, called them "family banks" that would take deposits (without charge or a minimum balance requirement and pay interest) and make loans to families and small business; they would operate in conjunction with Sears' real estate, insurance and brokerage business.

Chairman Volcker strongly opposes consumer banks on the grounds that they are simply a specialized nonbank bank. The "family bank," an unhappy Independent Bankers Association of America (IBAA, which represents mainly smaller banks) recently noted, is "skillfully wrapped in God, motherhood and country...but is nothing more than a nonbank bank in drag."

The fierce *intra*- as well as inter-industry debate these developments have caused is reverberating in Congress. Senate Banking Committee Chairman Jake Garn (R-UT), for example, has tied any closing of the nonbank bank loophole to other issues involving competitive equity and the financial structure. These include expanded lending and investment authority and the issue of interstate banking. In contrast, House Banking Committee

Chairman St Germain (D-RI) clings tenaciously to the view that the question of expanded powers for banks should be addressed only *after* (1) closing the nonbank bank loophole and (2) addressing the issues of deposit insurance and the safety and soundness of the financial system. The latter issue, he notes, is underscored by the recent Continental Illinois crisis and by the rising number of banks and savings and loans (S&Ls) on regulators' "problem" lists.

Vox populi: gopher prairie and central city
In the meantime, back in the trenches, the American Bankers Association (ABA) and the Association of Bank Holding Companies (ABHC) are in an ongoing dispute with the IBAA over the interstate banking issue.

In February, the ABA endorsed proposals that the nonbank bank loophole be closed (with the July 1983 grandfather date) but only on two conditions. One is that Congress specifically authorize regional banking compacts with a trigger requiring full interstate banking after five years for those states that enact regional legislation in the interim. The other condition is that the powers of BHCs (and their subsidiaries) be broadened to include the underwriting of municipal revenue bonds, mortgage-backed securities and commercial paper, plus authority to offer money market mutual funds (which the Federal Reserve Board also supports) *and* engage in real estate investment development and brokerage and insurance underwriting and brokerage.

For its part, the ABHC also opposes plugging the nonbank bank loophole without geographical and product deregulation, noting that the large money center banks hold 31 percent of bank assets but only 15 percent of relatively stable consumer deposits. It thus envisions the elimination or modification of current geographical and product restrictions as a means of reducing the risks inherent in the asymmetrical structure of the money center banks' assets and liabilities—Continental Illinois representing a case in point.

Predictably, the ABA and ABHC proposals elicited outrage from the 8,000 member IBAA, which called the conditional, or "linkage", approach "rotten" and claimed that this approach is precisely what forestalled loophole plugging efforts in the House last year. The IBAA's Executive Director recently noted that while 90 percent of his organization's members oppose interstate banking *per se*, some would rather see interstate restrictions lifted altogether than go the route of regional compacts. Nationwide banking of course would increase the number of potential buyers of local banks.

The stance of the securities and insurance industries may further complicate the efforts to plug the nonbank bank loophole. Those industries seem certain to continue to oppose any significant broadening of bank powers, and their track record in Congress thus far has been fairly good.

Vox magistratis
In February, the U.S. District Court, in response to a suit filed by the Florida Bankers Association and the IBAA, issued a preliminary injunction restraining the Comptroller from granting final approval to charters for nonbank banks. It did so on the grounds that the Comptroller's authority only covered the chartering of *banks*, and that Congress did not intend to remove nonbank banks from the provisions of the Bank Holding Company Act. In April, the U.S. Appeals Court in Atlanta, in a different case, ruled that it was not Congress' intent to allow banks to use nonbank banks as a guise for collecting deposits across state lines.

However, last September, the U.S. Circuit Court in Denver, in a suit brought by the Dimension Financial Corporation of Kansas City (which is planning to operate thirty-one nonbank banks in twenty-five states), ruled that in 1982 and 1983 the Fed exceeded its authority in an initial attempt to close the nonbank bank loophole. The Fed had expanded its definition of demand deposits to include NOW accounts and its definition of commercial loans to include virtually all loans other than personal loans. The Court said that the Fed's action "simply was a device to accomplish an end—a change in the Board's jurisdiction."

Recently, the Supreme Court agreed to hear the Denver case on appeal by the Board of Governors, with the IBAA appearing in its support. It is the view at the Board that the Circuit Court "misread or ignored the relevant legislative history" and Congressional intent governing the Board's responsibilities under the Bank Holding Company Act. These responsibilities include maintaining the separation of banking and commerce. (In addition, The Monetary Control Act of 1980 specifically groups NOW accounts with demand deposits in its definition of "transactions accounts.")

Regulatory reform

Still another potentially important catalyst for change is the Bush Task Group proposals for reform of the bank regulatory structure, which have been formalized and recently submitted to Congress. In the view of many in Congress, a restructuring of the bank regulatory apparatus not only is essential to restoring confidence in the safety and soundness of depository institutions (their primary concern), but also to ensuring that future financial development will occur in a manner that allows institutions to compete on an equitable basis. Whether implementation of the Bush proposals would in fact achieve this is a matter of some dispute, but *a priori*, many in Congress believe that regulatory reform should precede, or at least accompany, further moves to deregulate geographical and product markets.

In this connection, one of the Bush recommendations would place responsibility for merger and acquisition analyses solely in the hands of the Justice Department rather than (as at present) in the three separate federal banking agencies. This means that the Justice Department will be responsible for developing appropriate measures for assessing regional and/or national "concentration" and for answering such presumably relevant questions as "at what point does size (or as some would argue, "success") become socially unacceptable?" and (with an eye to the joint ventures and franchising arrangements that probably will be essential to the survival of the "little guys") "exactly where are the dividing lines between competition, cooperation and collusion?"

Deposit insurance reform

Closely related to both the matter of regulatory reform and the "safety and soundness" of depository institutions is reform of the deposit insurance system. Underlying this issue is the broader one of the extent to which the federal "safety net" should (as it clearly has done in some cases) blunt market discipline as a means of enforcing better decision-making on the part of institution managers, stockholders and depositors alike. Inevitably, these considerations are bound to the question of expanded powers and geographical deregulation, and to the potential increases in concentration and increases (or decreases) in risk that will result.

By definition, the larger an institution the greater the potential risk to the insurance fund especially if, as in the Continental Illinois case, public policy decides that considerations of safety and soundness require that *all* depositors be protected regardless of the size of their deposits. Conversely, while geographic and at least a modest degree of product deregulation conceivably should work in the direction of reducing market risk, risk actually could be increased to the extent that market opportunities rather than the "safety net" are allowed greater latitude to influence the decisions of institutional managers and their customers.

March of technology

The continuing "march of technology" and related court decisions also will ensure that deposit and payments services are available to households and businesses on a nationwide basis.

For example, in February, the Appeals Court in New York (in Independent Bankers of New York vs. Marine Midland) reversed a District Court and upheld a ruling of the Comptroller that an automated teller machine (ATM) used but not owned by a bank (in this case, one owned by a grocer and leased by a bank) is not a branch of the bank. The lower court had interpreted the MacFadden Act, which defines a branch as any national bank facility at which deposits are received and checks paid or money lent, to include ATMs used but not owned by a national bank. However, the Appeals Court stated that the language of MacFadden was not determinative and that a rigid application of a law written in 1927 to new technology fails to confront economic realities and would lead to anomalous results.

The significance of the Appeals Court ruling (if it stands) is that currently some 16,000 ATMs are tied to 200 networks processing 60 million transactions a month, and about 100 of these networks operate on an interstate basis. Significantly, the Appeals Court also noted that ATMs are not even the cutting edge of the new technology, and that the wave of the future involves point-of-sale and home banking systems, which is precisely what some (including in the Fed) were arguing many years ago. In any case, the court noted that it simply would "defy common sense" to consider a home computer as a branch of a bank.

The remaining question, therefore, seems to be whether such banking services will be provided by traditional banking organizations. The answer lies in the resolution of the nonbank bank issue, as well as in the outcome of various regulatory reform proposals now before Congress.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/10/85	Change from 7/3/85	Change from 7/11/84 Dollar	Percent[7]
Loans, Leases and Investments[1] [2]	192,733	− 434	11,005	6.0
Loans and Leases[1] [6]	173,797	− 604	11,045	6.7
Commercial and Industrial	51,402	− 117	1,355	2.7
Real estate	63,498	109	2,892	4.7
Loans to Individuals	34,732	44	6,116	21.3
Leases	5,432	33	392	7.7
U.S. Treasury and Agency Securities[2]	12,124	165	129	1.0
Other Securities[2]	6,813	6	− 167	− 2.3
Total Deposits	197,974	−3,597	8,182	4.3
Demand Deposits	47,278	−3,141	1,476	3.2
Demand Deposits Adjusted[3]	31,831	777	1,212	3.9
Other Transaction Balances[4]	13,967	− 221	1,517	12.1
Total Non-Transaction Balances[6]	136,729	− 234	5,188	3.9
Money Market Deposit Accounts—Total	44,699	44	6,273	16.3
Time Deposits in Amounts of $100,000 or more	37,711	− 280	− 2,166	− 5.4
Other Liabilities for Borrowed Money[5]	22,818	− 54	3,912	20.6

Two Week Averages of Daily Figures	Period ended 7/1/85	Period ended 6/17/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	21	76
Borrowings	91	11
Net free reserves (+)/Net borrowed(−)	− 69	65

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change