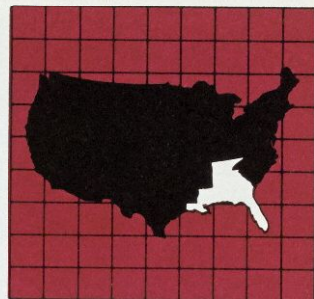


# Economic Review



FEDERAL RESERVE BANK OF ATLANTA

MAY 1983

## Special Issue: INTERSTATE BANKING

- TAKING INVENTORY ● ALTERNATIVE AVENUES
- INTERSTATE EXPANSION AND BANK COSTS ●
- FINANCIAL CONGLOMERATES ● CAPITAL ADE-
- QUACY RESTRICTIONS ● TECHNOLOGY'S ROLE
- THE CANADIAN EXPERIENCE ● TRADE GROUPS'
- VIEWES ● REGIONAL FORCES



# Waves of Change



# Economic Review



FEDERAL RESERVE BANK OF ATLANTA

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To the reader:

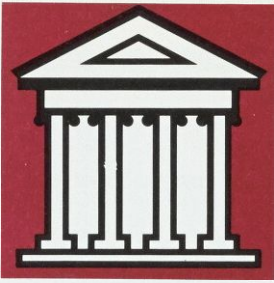
The barriers that have separated segments of the financial services industry since the 1930s are under serious attack. Market forces constitute a gathering wave of change that threatens to render the old barriers obsolete. This issue, coordinated by the Atlanta Fed's Financial Structure team, focuses on one of those barriers.

In the 1930s, Congress enacted banking legislation that effectively constructed three "walls" intended to separate and insulate various types of financial institutions. The three walls may be labelled the "Glass-Steagall wall" (which separated commercial banking from the securities business), the "Regulation Q wall" (which limited price competition among banks by imposing interest rate ceilings), and the "McFadden wall" (which was intended to loosen branching restrictions within states but effectively prohibited interstate banking). In 1956, The Douglas Amendment to the Bank Holding Company Act augmented the McFadden wall by prohibiting bank holding companies from acquiring banks outside their home office state unless the laws of the target state explicitly provide for such entry.

All three walls are showing signs of decay. Competitive market forces within the financial service industry are wearing down the Regulation Q wall. They also are putting serious strains on the Glass-Steagall wall as all depository institutions gain authority to offer expanded products.

The McFadden-Douglas wall remains intact, but market forces are surging around and over it. Questions concerning the prohibition of interstate banking will become more important as price and product deregulation continues. This special issue of the **Economic Review** examines the situation surrounding this third wall: where does interstate banking stand now and how is it likely to develop in the future?





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## Interstate Banking: Taking Inventory

*U.S. banking organizations now control over 7,000 interstate offices. Even if present prohibitions are lifted, however, the evidence suggests that interstate bank expansion will evolve slowly and will be limited to the more attractive markets.*

Although interstate banking is prohibited by the McFadden Act and the Douglas amendment to the Bank Holding Company Act, the fact is that banking organizations are providing financial services across state lines and have been doing so for some time. Four gateways allow commercial banking organizations to offer financial services on an interstate basis. First, "grandfather" provisions of banking legislation allow some banking organizations to maintain full-service commercial banks in more than one state. Second, the Garn-St Germain Depository Institutions Act of 1982 allows banks and savings and loan associations to acquire failing institutions across state lines. Third, and perhaps more importantly, the 4(c)8 provisions of the Bank Holding Company Act allow bank holding companies to establish or acquire nonbank subsidiaries that are not subject to the prohibitions on interstate banking. And fourth, other nonbank subsidiaries may establish offices across state lines, i.e. loan production offices and Edge Act corporations, allowing their parent organization to provide financial services on an interstate basis.

In addition, the BHC Act allows bank holding companies to acquire or establish banking subsidiaries in states which explicitly permit such entry. This article will describe various ways in which bank holding companies provide interstate financial services and will inventory their activities on a state-by-state basis. This should give us some idea of the extent to which bank holding companies are actively supplying interstate financial services. The numbers presented in this inventory represent the best available information but may not include all activities or offices. Therefore, the figures represent activities and offices documented by our inventory and should be viewed as a minimum.

### **Grandfathered Interstate Banking**

Legislation and regulation tend to follow actual events in the marketplace. This is especially



**Table 1.** Foreign and Domestic Bank Holding Companies With Subsidiary Banks In More Than One State

Bank Holding Company	Home State	Number of States	States In Which Banks Are Located
First Interstate Bancorporation	CA	11	AZ, CA, CO, ID, MT, NM, OR, NV, WA, WY, UT
First Bank System, Inc	MN	5	MN, MT, ND, SD, WI
Northwest Bancorporation	MN	7	IA, MN, MT, NE, ND, SD, WI
Otto Bremer Foundation	MN	3	MN, ND, WI
Financial General Bancshares, Inc.	DC	5	DC, MD, NY, TN, VA
General Bancshares Corporation	MO	3	IL, MO, TN
First Security Corporation	UT	3	ID, WY, UT
Citicorp	NY	3	DE, NY, SD
Bank of Montreal*	NY	2	CA, NY
Canadian Imperial Bank of Commerce*	NY	2	CA, NY
The Bank of Tokyo, Ltd.*	CA	2	CA, NY
Barclays Bank Limited*	NY	2	CA, NY
The Sumitomo Bank, Ltd.*	CA	2	CA, HI
The Royal Bank of Canada*	NY	2	NY, PR
Banco Central, S.A.*	NY	2	NY, PR
J.P. Morgan & Company	NY	2	DE, NY
The Girard Company	PA	2	DE, PA
NCNB Corporation	NC	2	FL, NC
Chase Manhattan Corporation	NY	2	DE, NY
Provident National Corporation	PA	2	DE, PA
Northern Trust Corporation	IL	2	FL, IL
Maryland National Corporation	MD	2	DE, MD
Philadelphia National Corporation	PA	2	DE, PA
First Maryland Bancorp	MD	2	DE, MD
Equitable Bancorporation	MD	2	DE, MD
Chemical New York Corporation	NY	2	DE, NY
Manufacturers Hanover Corporation	NY	2	DE, NY
Pittsburg National Corporation	PA	2	DE, PA

Source: Federal Reserve Board as of 12/31/82  
 \*Foreign banking organizations

true in banking. Market participants first become creative in terms of supplying financial services, and then legislators and regulators react to the evolving market circumstance. Reacting to changing market conditions means that legislators are constantly faced with restricting given activities after innovative organizations have engaged in the activity. In some cases it would be detrimental or impossible to require the organization to cease the activity even though a general prohibition is deemed desirable. In such cases, one equitable approach is to allow the innovative organization to continue but not expand the activity in question. Such a clause is then written into the legislation and is termed a "grandfather provision." A number of domestic and international banking organizations enjoy

such grandfather provisions with respect to prohibitions on interstate banking.

We were able to identify 21 domestic bank holding companies that controlled banking subsidiaries in more than one state. One of these organizations controlled banking subsidiaries in 11 states, one had banking subsidiaries in seven states, two had subs in five states, four had banking subsidiaries in three states and the remainder were represented in only two states (Table 1). In total these 21 banking organizations control 138 banks and 1,369 branch offices in 22 states. This means that almost half of our states house banks controlled by out-of-state holding companies.

In addition to domestic holding companies controlling interstate banks, seven international



**Table 2.** Foreign Banking Organizations Controlling Interstate Offices

State	Number of Foreign Banking Organizations Controlling Interstate Offices by State of Residence	Number and Type of Interstate Office Locations by Type of Office				Total Number of Interstate Offices Controlled by Foreign Banking Organizations Headquartered Outside the State
		Banks	Branches	Edge Acts	Agencies	
California	26	8	2	2	63	75
District of Columbia	—	—	1	—	—	1
Florida	1	—	—	6	22	28
Georgia	—	—	—	—	10	10
Hawaii	—	1	—	—	2	3
Illinois	1	1	36	3	—	40
Louisiana	—	—	—	—	1	1
Massachusetts	1	—	4	—	—	4
New York	58	3	37	2	18	60
Oregon	—	—	7	—	—	7
Pennsylvania	—	—	6	—	—	6
Texas	—	—	—	9	—	9
Washington	—	—	10	—	—	10
	103*	13	103	22	116	254

\*16 of these organizations that have offices in more than one state are international organizations having no resident state—i.e. agency offices of international banks.

Source: Federal Reserve Bank of New York, as of 6-30-82.

banking organizations control banks in more than a single state. Table 1 identifies and locates these organizations. Prior to the Bank Holding Company Act of 1956, international organizations could establish banks in more than one state. Following 1956, however, any international organization controlling more than one U.S. bank fell under the Holding Company Act and became subject to the Douglas Amendment. Grandfather provisions allowed these organizations to continue their interstate system but restricted the organization from expanding outside its declared home state. In total, seven international bank holding companies control seven banks in states other than the state in which they are based. Of the seven foreign holding companies controlling banks in more than one state, five declared New York as their state of residence and two declared California (Table 2).

Fifty-three international banks have interstate branches, 25 of which are home officed in New York and 24 in California. As Table 2 shows, 71 percent of their interstate branches (73 in

number) are located in either New York or Illinois. As would be expected, most of the interstate branches of foreign banks are located in our larger cities and trade centers. These organizations then have established an interstate presence of full service banks in some of our most attractive markets.

In addition to the 103 interstate branches established by foreign banks, they have established 116 interstate agency offices and 22 interstate Edge Act offices. This brings the total number of interstate offices of foreign banks and holding companies to 254 (Table 2).

The door to interstate banking is not completely closed. The Douglas Amendment allows bank holding companies to acquire banks on an interstate basis if the target state passes legislation that specifically allows out-of-state holding companies to acquire instate banks. To date, five states have passed such legislation.<sup>1</sup> Two other

<sup>1</sup>Utah passed reciprocal legislation in 1981 but repealed same in 1983.



**Table 3.** Interstate Savings and Loan Associations and Their Geographic Coverage  
(March 7, 1983)

Parent	Home Office Locations	Interstate Locations
1. Northeast Savings, F.A.	CT	CT, MA, NY
2. City FS & LN	NJ	NJ, FL
3. Empire of America, FSA	MI	MI, FL, NY, TX
4. Carteret S&LA, FA	NJ	NJ, FL
5. Perpetual American FS&LA	VA	VA, DC, MD
6. Home Savings of America, FS & Los Angeles	CA	CA, FL, IL MO, TX
7. Glendale FS&LA	CA	CA, FL
8. First Nationwide Savings FS & LA	CA	CA, NY, FL
9. California FS & LA	CA	CA, GA, FL, NV
10. World S&LA, A FS&LA	CA	CA, KS, CO
11. First FS&LA of Arizona	AZ	AZ, TX
12. Bay Savings Bank	MI	MI, VA
13. National Permanent FS&LA	DC	DC, MD
14. First FS&LA of Puerto Rico	PR	PR, VI
15. Charter FS&LA	GA	GA, AL
16. Equitable FS&LA	MD	MD, DC
17. Union FS&LA of Evansville	IN	IN, KY
18. Farm and Home SA	MO	MO, TX
19. Mountainwest S&L	UT	UT, WY
20. The Benj Franklin FS&LA	OR	OR, ID, WA, UT

Source: Federal Home Loan Bank Board

states, Delaware and South Dakota, allow entry through limited purpose banks, and both have actually experienced entry by out-of-state holding companies. In addition, Iowa, Illinois, and Florida allow expansion by out-of-state banking organizations that operate banks or trust companies under grandfather provisions.

Although interstate deposit-taking is prohibited, many interstate banking services exist, and more could develop in the future even without changes in the federal laws prohibiting interstate banking. Three recent avenues for establishing an interstate banking presence or position are through the purchase of up to 5 percent of voting stock, preferred convertible stock, and franchise agreements among banks.

The Bank Holding Company Act specifies that it "shall be unlawful, except with the prior approval of the Board, . . . for any bank holding company to acquire directly or indirectly ownership or control of any voting shares of any bank, if after such acquisition, such company will directly or indirectly own or control more than 5 per

cent of the voting shares of such bank. . . ."<sup>2</sup> This clause leaves the door open for bank holding companies to acquire up to 5 percent of the voting shares of a bank without Board approval. As a result, some bank holding companies have taken the opportunity to invest in banks across state lines, establishing associations of banks that may work together for their common benefit. These investments have taken the form of 4.9 percent voting stock ownership, nonvoting preferred stock that automatically converts to voting stock should the prohibition on interstate banking be removed, or simple franchise agreement among banks.

Whatever the path, the result is a potential interstate network of banks large enough and geographically dispersed enough to offer products and services no one bank may have been capable of offering separately. These formal and informal agreements represent a form of geographic

<sup>2</sup>Section 3(a) Bank Holding Company Act of 1956.



positioning for the day when interstate powers are granted. Texas Commerce Bankshares, for example, has investments in banks in Wyoming, Colorado, Arizona, Oklahoma and Louisiana.<sup>3</sup> While no comprehensive list of these investments and agreements was available, we are aware of these methods to establish an interstate presence. To date the Federal Reserve Board has approved two preferred stock deals, has disapproved one which is being restructured and has at least seven others pending.

The Bank Holding Company Act does not prohibit individuals from acquiring more than one bank. Neither does it require individuals to file an application with the Board regarding the acquisition of bank stock either within a given state or on an interstate basis.<sup>4</sup> We know that interstate banking groups controlled by individuals exist, but we have no accurate measure of the number of these groups or the number and geographic dispersion of the banks involved. To this extent, our inventory again is understated.

Another avenue for interstate expansion was opened by the emergency provisions of the Depository Institutions Act of 1982 allowing out-of-state organizations to acquire troubled banks and insured mutual savings banks under certain circumstances.<sup>5</sup> Although these provisions have not been used to allow interstate bank acquisitions to date, they do provide an avenue for interstate expansion.<sup>6</sup> The Federal Home Loan Bank Board began allowing interstate mergers of savings and loans in 1981, allowing only four that year. In 1982, however, 16 such mergers were allowed and today 29 interstate savings and loan systems exist (Table 3). Although these cases are limited, the provisions of the Garn-St Germain Depository Institutions Act and the fact that the Federal Home Loan Bank Board is actively allowing S&Ls to merge across state lines indicates increasing pressure for further relaxation of the prohibition on interstate banking.

Commercial banks are the only financial services suppliers effectively constrained geographically today, and even these constraints do

**Map 1**  
Resident State of Bank Holding Companies Controlling Interstate 4(c)8 Subsidiaries



Total: 139

not apply to all commercial banks under all conditions. The fact that a commercial banking organization in one state may acquire a failing institution in another state inevitably will result in commercial banks facing competition from interstate banking organizations.<sup>7</sup> Because of the criteria for such acquisitions, the degree of competition may be limited at first; yet as the failing institution recovers and takes advantage of its association with an interstate parent, local bank competitors will resent such relationships. Geographically constrained banking organizations will feel that a two way competitive street is necessary. As the number of such acquisitions across state lines increases, support for repeal of interstate bank prohibitions will also increase. The emergency provisions of the Depository

<sup>3</sup>United States Banker, January 1983, p. 15.

<sup>4</sup>See "Change in Bank Control Act," Title VI of the Financial Institutions Regulatory and Interest Rate Control Act of 1978.

<sup>5</sup>See footnote 1.

<sup>6</sup>The Depository Institution Act of 1982 allows closed insured commercial banks with assets of \$500 million or more and insured mutual savings banks with assets of \$500 million or more and in danger of failing to be acquired by an out-of-state bank or bank holding company with priority given in the following order: acquisition of similar institutions in the same

state; acquisition by same type of institution in different states; acquisition by different types of institutions in the same state; and acquisition by different types of institutions in different states.

<sup>7</sup>The degree of interstate expansion through the emergency provisions will be limited by the requirement that the failing institution must have at least \$500 million in assets. It may be possible, however, for a number of weak institutions to be consolidated in order to meet this requirement. An organization in Tennessee is currently attempting such a consolidation.  
<sup>8</sup>Section 2(c) of the Bank Holding Company Act of 1956.



Institutions Act of 1982 may in fact be unlocking the door to full interstate banking.

Given the number of interstate banking organizations, the extent of their geographic coverage, the other unmeasured forms of interstate banking and the potential avenues for still further expansion, the actual extent of interstate banking is probably far greater than might be assumed given the laws prohibiting it.

## Nonbank Subsidiaries

For purposes of the Bank Holding Company Act, a bank is defined as "... any institution ... which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans."<sup>8</sup> Therefore an organization that offers both demand deposits and commercial loans may be defined as a commercial bank, and, hence, would fall under the interstate banking restrictions. The laws prohibiting interstate banking limit the ability of a formal banking organization to offer both demand deposits and commercial loans at a single location in more than one state. But by separating the demand deposit and commercial lending functions it is possible for banking organizations to circumvent the interstate restrictions and provide interstate financial services. Indeed, nothing prevents a commercial bank in one state from advertising and accepting demand deposits or savings deposits from consumers in another state. Many large commercial banks aggressively sell large certificate of deposits on an interstate basis. They employ calling officers to seek out major accounts nationwide, and they market their credit cards nationwide. In addition, commercial banks are offering such financial services as cash management, electronic funds transfer accounts, loan participations and a variety of correspondent banking services that know no state boundary. These are all examples of services offered across state lines that do not require the bank to establish a physical presence.

By separating the demand deposits and commercial lending functions, however, a banking organization can establish a physical presence across state lines. One way for bank holding companies to accomplish this is through the creation or acquisition of nonbank subsidiaries. The nonbank subsidiaries do not constitute a commercial bank and, hence, are free to open offices on an interstate basis. National banks

may undertake a number of the same 4(c)8 type activities allowed to bank holding companies (Table 4). For the most part, however, these activities are constrained to the state in which the parent bank is located.

## Identifying Interstate 4(c)8 Offices

With the assistance of the eleven other Federal Reserve District Banks, we were able to piece together a composite picture of holding companies throughout the nation that controlled interstate 4(c)8 subsidiaries and the number of interstate offices each controlled. Although an application is required prior to a 4(c)8 subsidiary opening a new office, no consolidated records were available. Each District Federal Reserve Bank compiled a list of holding companies with interstate 4(c)8 offices and provided the office locations on a state-by-state basis. In a few instances it was necessary to contact holding companies directly to obtain the desired information. This article presents the best information available on 4(c)8 interstate activity, but the data may not be 100 percent inclusive. The numbers represent an actual count of those institutions and office locations of those institutions we identified as being involved in 4(c)8 services on an interstate basis. Therefore, the numbers may understate the extent of interstate activity.

In total there are 3,201 one-bank holding companies and 430 multibank holding companies in the United States (Table 5). Of the 3,631 holding companies capable of establishing or acquiring interstate offices of 4(c)8 subsidiaries, only 139 or approximately four percent elected to do so. Of those 139, 68 were one-bank and 71 were multibank holding companies. One common characteristic of holding companies electing to go interstate through their 4(c)8 subsidiaries was their absolute size. Of the 50 largest banking organizations in the country, 42 have interstate 4(c)8 subsidiaries. Of the 100 largest banking organizations, 70 have 4(c)8 subsidiaries that control interstate offices; of the top 150 organizations, 102 have interstate 4(c)8 subsidiaries. Therefore, as a generalization, large bank holding companies are the most likely to provide interstate financial services through offices of their 4(c)8 subsidiaries. They are also the organizations most likely to undertake interstate banking if or when the prohibitions are lifted.

Table 5 also indicates that these 139 holding companies control 382 4(c)8 subsidiaries which collectively have at least 5,500 offices outside



## Allowable Nonbank Activities

The Bank Holding Company Act of 1956 as amended in 1970 defines a bank holding company as—"any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of this Act." The term company includes all legal entities except individuals—that is, corporations, partnerships, trusts or associations. Individuals are excluded and consequently may own any number of banks or other financial institutions in any number of states without coming under the provisions of the act. For purposes of the act, the term "control" was defined as controlling directly or indirectly 25 percent or more of any class of voting securities of the bank or company, or controlling the election of a majority of directors or trustees of the bank or company, or the Board of Governors of the Federal Reserve System determines that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.<sup>9</sup> This latter provision gives the Board of Governors wide latitude in determining what constitutes control, and hence, what is or is not a holding company.

Section 4(c)8 of the Bank Holding Company Act states the criteria the Board must apply before allowing bank holding companies to engage in certain nonbank activities. Some of those nonbank activities are prohibited to individual banks, but the majority are activities in which nationally chartered banks may engage.<sup>10</sup> Under 4(c)8, a bank holding company may be exempted from the general prohibition against acquiring or establishing nonbank activities and allowed to acquire.

"shares of any company the activity of which the Board after due notice and opportunity for hearing has determined (by order or regulation) **to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.** In determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices."

To be considered a permissible nonbank activity for bank holding companies, the activity must pass two

tests. First, it must be closely related to the activities in which banks engage. This is a rather vague criterion in light of the "incidental powers" accorded banks through Section 8 of the National Bank Act of 1864 which states that banks may "exercise... all such incidental powers as shall be necessary to carry on the business of banking...". Given this vagueness it is not surprising that the Board of Governors has no published statement of the criteria it uses to determine activities closely related to banking. Researchers have observed, however that the Board has approved activities in which banks have historically engaged, or activities complementing services normally provided by banks or activities in which banks clearly possess technical skills.<sup>11</sup> If the activity satisfies at least one of these criteria, it may be proclaimed a permissible activity if it also passes the second test: that providing the service through a nonbank subsidiary may reasonably be expected to produce net public benefits.

The Board may approve a nonbank activity either by order or by regulation—adding the activity to the "laundry list" of approved activities as set forth in Regulation Y, Section 4(c)8. If the activity is approved by order, then every future applicant wishing to undertake that activity must justify the activity to the Board. Effectively, this amounts to a case-by-case review and opinion. On the other hand, if the activity is approved and added to approved activities listed in the regulation, a future applicant need not justify the activity and an application may be approved under delegated authority at the Reserve Bank level if all other conditions for delegated authority are met.

To date, the Board has approved and added to the "laundry list" 17 activities in which bank holding companies may engage by either establishing *de novo* nonbank subsidiaries or acquiring nonbank subsidiaries. The approved activities are set forth in Table 4.

Through an application process, one bank and multi-bank holding companies may gain approval to establish a nonbank subsidiary to engage in any or a combination of activities. By definition, a nonbank subsidiary is not a bank and, hence, does not fall under regulations or laws that apply only to banks. The nonbank entities are, therefore, capable of unrestricted geographic expansion both intrastate and interstate.<sup>12</sup> Since the vast majority of the approved nonbank activities are activities in which banks may engage, i.e. "activities which are closely related to banking or managing or controlling banks...", the 4(c)8 provisions effectively allow bank holding companies to provide financial services similar to those provided by banks but on an interstate basis.

<sup>9</sup>See Statutory Appendix to Regulation Y.

<sup>10</sup>See Dale S. Drum, "Nonbanking Activities of Bank Holding Companies **Economic Perspective**, Federal Reserve Bank of Chicago March/April, 1977.

<sup>11</sup>See for example, Harvey Rosenblum, "Bank Holding Companies: An Overview" **Business Conditions**, Federal Reserve Bank of Chicago.

August, 1973; or Samuel H. Talley, "Developments in the Bank Holding Company Movement", Proceedings of a Conference on Bank Structure and Competition, 1972, Federal Reserve Bank of Chicago.

<sup>12</sup>In two cases, bank holding companies have received approval to acquire troubled S&Ls with the condition that bank branching laws would apply to the acquired S&Ls.



**Table 4.** Permissible Nonbank Activities for Bank Holding Companies Under Section 4(c)8 of Regulation Y  
February, 1983

Activities permitted by regulation	Activities permitted by order	Activities denied by the Board
<ol style="list-style-type: none"> <li>1. Extensions of credit<sup>2</sup> Mortgage banking Finance companies: consumer, sales, and commercial Credit cards Factoring</li> <li>2. Industrial bank, Morris Plan bank, industrial loan company</li> <li>3. Servicing loans and other extensions of credit<sup>2</sup></li> <li>4. Trust company<sup>2</sup></li> <li>5. Investment or financial advising<sup>2</sup></li> <li>6. Full-payout leasing of personal or real property</li> <li>7. Investments in community welfare projects<sup>2</sup></li> <li>8. Providing bookkeeping or data processing services<sup>2</sup></li> <li>9. Acting as insurance agent or broker primarily in connection with credit extensions<sup>2</sup></li> <li>10. Underwriting credit life, accident and health insurance</li> <li>11. Providing courier services<sup>2</sup></li> <li>12. Management consulting for all depository institutions</li> <li>13. Sale at retail of money orders with a face value of not more than \$1000, travelers checks and savings bonds<sup>1, 2</sup></li> <li>14. Performing appraisals of real estate<sup>1</sup></li> <li>15. Issuance and sale of travelers checks<sup>1</sup></li> </ol>	<ol style="list-style-type: none"> <li>1. Issuance and sale of travelers checks<sup>2, 6</sup></li> <li>2. Buying and selling gold and silver bullion and silver coin<sup>2, 4</sup></li> <li>3. Issuing money orders and general- purpose variable denominated payment instruments<sup>1, 2, 4</sup></li> <li>4. Futures commission merchant to cover gold and silver bullion and coins<sup>1, 2</sup></li> <li>5. Underwriting certain federal, state and municipal securities<sup>1, 2</sup></li> <li>6. Check verification<sup>1, 2, 4</sup></li> <li>7. Financial advice to consumers<sup>1, 2</sup></li> <li>8. Issuance of small denomination debt instruments<sup>1</sup></li> <li>9. Arranging for equity financing of real estate<sup>1</sup></li> <li>10. Acting as futures commissions merchant<sup>1</sup></li> <li>11. Discount brokerage<sup>1</sup></li> <li>12. Operating a distressed savings and loan association<sup>1</sup></li> <li>13. Operating an Article XII Investment Co.<sup>1</sup></li> <li>14. Executing foreign banking unsolicited purchases and sales of securities</li> <li>15. Engaging in commercial banking activities abroad through a limited purpose Delaware bank<sup>1</sup></li> <li>16. Performing appraisal of real estate and real estate advisor and real estate brokerage on nonresidential properties.<sup>1</sup></li> <li>17. Operating a Pool Reserve Plan for loss reserves of banks for loans to small businesses<sup>1</sup></li> <li>18. Operating a thrift institution in Rhode Island</li> <li>19. Operating a guarantee savings bank in New Hampshire<sup>1</sup></li> <li>20. Offering informational advice and transactional services for foreign<sup>1</sup> exchange services</li> </ol>	<ol style="list-style-type: none"> <li>1. Insurance premium funding (combined sales of mutual funds and insurance)</li> <li>2. Underwriting life insurance not related to credit extension</li> <li>3. Sale of level-term credit life</li> <li>4. Real estate brokerage (residential)</li> <li>5. Armored car</li> <li>6. Land development</li> <li>7. Real estate syndication</li> <li>8. General management consulting</li> <li>9. Property management</li> <li>10. Computer output microfilm services</li> <li>11. Underwriting mortgage guaranty insurance<sup>3</sup></li> <li>12. Operating a savings and loan association<sup>1, 5</sup></li> <li>13. Operating a travel agency<sup>1, 2</sup></li> <li>14. Underwriting property and casualty insurance<sup>1</sup></li> <li>15. Underwriting home loan life mortgage insurance<sup>1</sup></li> <li>16. Investment note issue with transactional character- istics<sup>1</sup></li> <li>17. Real estate advisory services<sup>1</sup></li> </ol>

<sup>1</sup>Added to list since January 1, 1975.

<sup>2</sup>Activities permissible to national banks.

<sup>3</sup>Board orders found these activities closely related to banking but denied proposed acquisitions as part of its "go slow" policy.

<sup>4</sup>To be decided on a case-by-case basis.

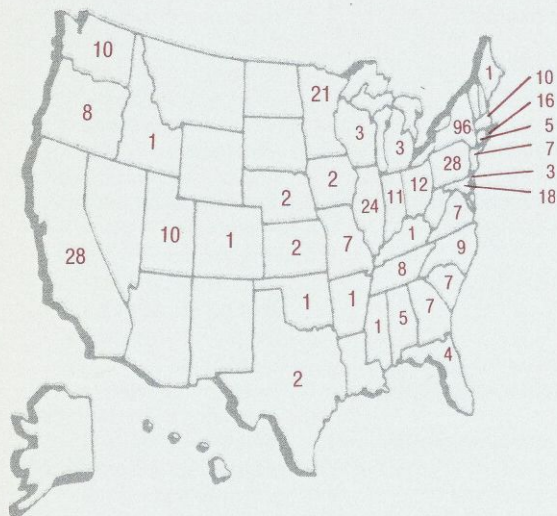
<sup>5</sup>Operating a thrift institution has been permitted by order in Rhode Island, Ohio, New Hampshire and California.

<sup>6</sup>Subsequently permitted by regulation.

Source: Federal Reserve Board

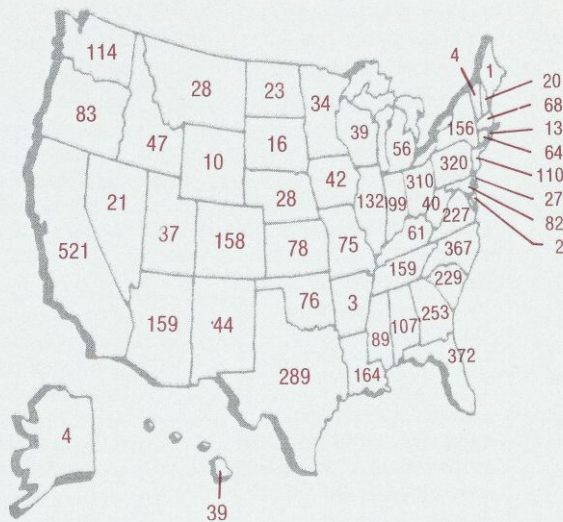


**Map 2**  
Number of Interstate Subsidiaries of Holding Companies  
Home Officed in the State



Total: 382

**Map 3**  
Total Number of Offices: All 4(c)8 Subsidiaries



Total: 5,500

the state in which the parent holding company resides. Map 1 indicates that 56 of these holding companies (41 percent of the total) with interstate 4(c)8 subsidiaries reside in 10 northeastern states (Maine, New York, Massachusetts, Rhode Island, Connecticut, Pennsylvania, New Jersey, Delaware, Maryland and Virginia). The highest concentration of holding companies controlling 4(c)8 subsidiaries with interstate offices is in the northeastern portion of the nation.

Map 2 shows the number of 4(c)8 subsidiaries controlled by holding companies home officed in a given state. In total the 139 holding companies control 382 4(c)8 subsidiaries with interstate offices. Approximately fifty percent of the 4(c)8 subsidiaries (191) have parent holding companies that reside in the Northeast, specifically the northeastern coastal states from Virginia to Maine plus Pennsylvania (Maine, New York, Massachusetts, Rhode Island, Connecticut, Pennsylvania, New Jersey, Delaware, Maryland and Virginia). And as Map 3 shows, these 191 subsidiaries controlled better than 64 percent (3,472) of all interstate 4(c)8 offices. Therefore, the vast majority of holding companies controlling 4(c)8 subsidiaries with interstate offices are

based in the Northeast. In fact, New York and Pennsylvania alone accounted for 22 percent (30) of all holding companies with interstate 4(c)8 subsidiaries. Holding companies in those two states controlled 124 separate interstate subsidiaries, 33 percent of the total, and 1,874 (34 percent) of the total interstate offices. This is not surprising given the number of large holding companies in this area. If interstate positioning through 4(c)8 subsidiaries is any indication, large organizations, especially those in the Northeast, are the most likely to become active in interstate banking if and when the laws permit.

### Types of Financial Services Provided

A nonbank subsidiary may provide more than one 4(c)8 activity at a given location. For instance, a nonbank subsidiary primarily engaged in consumer finance activity may also provide credit life insurance and leasing activities. Therefore, there is a difference between the number of 4(c)8 services provided and the number of 4(c)8 subsidiaries and the number of offices of 4(c)8 subsidiaries. Table 6 summarizes the number of 4(c)8 activities provided through



**Table 5. Bank Holding Companies, Number with Interstate 4(c)8 Subsidiaries and Offices of Interstate 4(c)8 Subsidiaries by State**

Home State of Holding Company	Total Number of Holding Companies Home Officed in State			Interstate Companies		
				Number of Holding Companies	Number of Subsidiaries	Number of Offices
	One-Bank	Multi Bank	Total			
Alabama	16	9	25	4	5	12
Alaska	3	1	4	—	—	—
Arizona	5	0	5	0	—	—
Arkansas	47	2	49	1	1	1
California	42	6	48	5	28	636
Colorado	104	22	126	1	1	1
Connecticut	7	3	10	2	5	13
D.C.	7	3	10	—	—	—
Delaware	12	1	13	1	3	1,171
Florida	48	29	77	3	4	50
Georgia	49	22	71	4	7	157
Hawaii	3	0	3	—	—	—
Idaho	6	1	7	1	1	2
Illinois	316	7	323	5	24	70
Indiana	66	1	67	3	11	38
Iowa	268	16	284	2	2	3
Kansas	323	8	331	2	2	2
Kentucky	43	1	44	1	1	5
Louisiana	47	1	48	—	—	—
Maine	2	4	6	1	1	1
Maryland	3	4	7	6	18	102
Massachusetts	14	13	27	4	10	34
Michigan	18	24	42	1	3	6
Minnesota	286	15	301	3	21	585
Mississippi	26	0	26	1	1	2
Missouri	175	40	215	7	7	7
Montana	34	7	41	—	—	—
Nebraska	283	0	283	2	2	2
Nevada	2	0	2	—	—	—
New Hampshire	6	4	10	—	—	—
New Jersey	8	11	19	4	7	17
New Mexico	19	4	23	—	—	—
New York	19	11	30	19	96	1,593
North Carolina	9	1	10	4	9	226
North Dakota	51	4	55	—	—	—
Oklahoma	250	6	256	1	1	1
Ohio	16	17	33	11	12	12
Oregon	3	5	8	2	8	27
Pennsylvania	32	3	35	11	28	283
Rhode Island	11	0	11	3	16	167
South Carolina	5	0	5	3	7	86
South Dakota	41	4	45	—	—	—
Tennessee	40	10	50	6	8	14
Texas	283	59	342	2	2	2
Utah	17	5	22	2	10	37
Vermont	4	1	5	—	—	—
Virginia	5	9	14	5	7	86
Washington	7	1	8	4	10	42
West Virginia	9	1	10	—	—	—
Wisconsin	82	28	110	2	3	7
Wyoming	29	6	35	—	—	—
<b>TOTAL</b>	<b>3,201</b>	<b>430</b>	<b>3,631</b>	<b>139</b>	<b>382</b>	<b>5,500</b>

Source: Federal Reserve Board Data Base as of December 31, 1981.

Note: Data on holding companies with interstate subsidiaries is based on data from the District Federal Reserve Banks except in the 11th and 12th Federal Reserve Districts where we contacted the holding companies. This data based on December 31, 1981, figures, is a snapshot of a constantly changing situation and is not intended as an exhaustive listing.



interstate offices of nonbank subsidiaries by section of the country. At least 4,613 offices of nonbank subsidiaries of out-of-state bank holding companies provide consumer finance services, by far the most popular type of interstate 4(c)8 activity for bank holding companies to engage in. The second most popular is the insurance agency activity (provided through 2,440 offices), followed by underwriting credit life (1,118 offices), servicing loans (1,995 offices), mortgage banking (623 offices) and leasing (580 offices).<sup>13</sup> Interstate offices that provide check verification, audit services, and credit cards are the least popular. Although these services are provided on an interstate basis, they don't require permanent physical presence.

The geographic distribution of these services is interesting. The South Atlantic (Census Region) states lead the nation in the number of activities provided through nonbank subsidiaries belonging to out-of-state holding companies. These South Atlantic states house 1,327 offices of out-of-state holding companies providing consumer finance services, 214 offices offering mortgage banking and 21 offices offering trust services. The Pacific states are the second most popular target for most 4(c)8 activities, but these states house less than half the number of activities provided through offices in the South Atlantic region. Quite obviously, a region's size plays a part in these statistics, but generally the primary targets for 4(c)8 activities appear to be the faster growing states with substantial populations. In terms of total number of activities offered through nonbank subsidiaries of out-of-state holding companies, California leads the way with 907, followed by Florida with 824, North Carolina with 769, Pennsylvania with 640, Ohio with 614, South Carolina with 558, Georgia with 557 and Texas with 542. The remaining 42 states house approximately the same number of activities offered through offices of nonbank subsidiaries of out-of-state holding companies as the total offered in these 8 states.

### **Interstate Offices by Primary Activity**

As noted above, more than one 4(c)8 activity may be provided through a single subsidiary office. Many activities are low profile and

normally provide a complementary service to some other 4(c)8 activity. For example, as Table 6 indicates, the insurance agent activity is provided at 2,440 locations, although the interstate offices of 4(c)8 subsidiaries primarily engaged in this activity number only 40. The same is true for underwriting credit life insurance; while credit life insurance is provided at 1,118 offices of 4(c)8 subsidiaries, only 56 are primarily engaged in this activity. Therefore, to assess the geographic extent to which bank holding companies are establishing a physical presence on an interstate basis, one should focus on the number of 4(c)8 offices by primary activity. A table detailing the number of these offices by primary activity and by region is available from the Atlanta Fed.

At least 5,500 offices of 4(c)8 subsidiaries are located outside the state in which the parent company resides. Four of the primary activities are what may be considered high profile activities: finance company, mortgage banking, industrial banking and trust services. While offices of some of the other primary activities establish the holding company's presence in an area, they are less visible to the public. In addition, these four highly visible activities accounted for 5,189 of the interstate 4(c)8 offices, or 95 percent of the total. Finance companies dominate as the most popular type of primary 4(c)8 activity. In total, subsidiaries of bank holding companies control 4,442 finance company offices outside the state in which the parent company resides. This one activity accounts for better than 80 percent of all interstate 4(c)8 offices.

A look at the geographic distribution of interstate offices of 4(c)8 subsidiaries may indicate which states or areas of the country will be the primary targets for interstate expansion if the prohibition on interstate banking is lifted. Map 3 shows by state the number of 4(c)8 offices controlled by out-of-state holding companies. In terms of total office locations, California has attracted more activity than any other state with 521 offices. Florida is a distant second with 372 offices, closely followed by North Carolina (367), Pennsylvania (320), Ohio (310) and Texas (289).<sup>14</sup> Five southeastern Atlantic coast states have attracted a good deal of the attention of out-of-state holding companies—Virginia, North

<sup>13</sup>Any location at which a customer may obtain credit life insurance which is reinsured by a holding company subsidiary is included in the 1,118 offices providing underwriting credit life.

<sup>14</sup>Pennsylvania has very attractive usury laws which may explain at least in part the degree of nonbank entry.



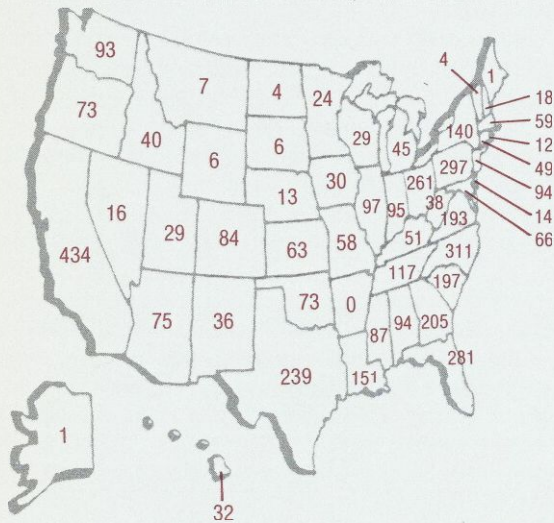
**Table 6.** Interstate Nonbank Subsidiaries: Location of Activities by Region

TYPE OF ACTIVITY										TOTAL
	New England	Mid Atlantic	South Atlantic	W. South Central	E. South Central	North Central	North Central-East	North Central-West	Pacific	
Mortgage Banking	19	27	214	47	61	74	32	80	69	623
Finance Company	149	536	1,327	466	389	565	208	652	321	4,613
Credit Cards	0	0	5	0	0	0	1	0	0	6
Factoring	1	5	10	9	3	3	1	12	4	48
Industrial Bank	2	0	29	1	1	2	18	23	49	125
Servicing Loans	47	140	334	83	32	105	45	106	103	995
Trust Company	0	4	21	0	2	1	13	7	20	68
Financial Advisor	2	2	29	17	1	17	1	12	11	92
Leasing	30	86	167	53	14	114	23	49	44	580
Investment in Community Welfare	0	0	0	0	0	4	0	4	4	12
Data Processing	2	3	6	4	1	9	16	3	10	54
Insurance Agent	72	230	836	253	236	251	97	273	192	2,440
Underwriting Credit Life	21	45	407	106	83	78	65	159	154	1,118
Management Consulting	0	0	2	3	0	0	1	2	2	10
Money Orders, Travelers Checks	0	0	113	2	42	12	0	4	4	177
Check Verification	0	0	2	0	1	0	0	0	0	3
Audit Services	0	0	0	0	0	0	4	0	1	5
Total Per Region	345	1,078	3,502	1,044	866	1,235	525	1,386	988	
Total for U.S.										10,969

Source: Federal Reserve Bank of Atlanta

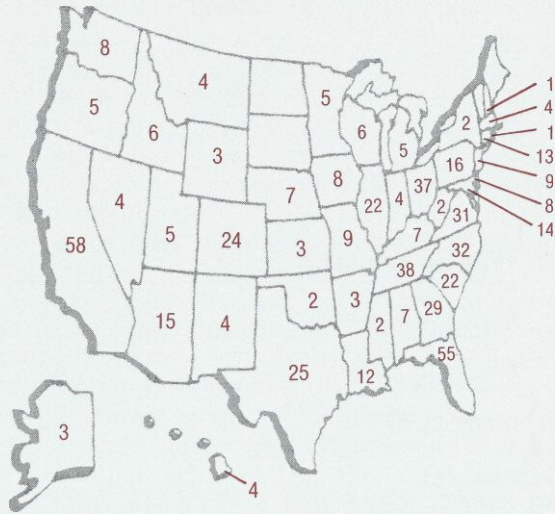


**Map 4**  
By Major 4(c)8 Activity and Number of Offices Located  
in each State  
Finance Companies



Total: 4,442

**Map 5**  
By Major 4(c)8 Activity and Number of Offices Located  
in each State  
Mortgage Banking



Total: 584

Carolina, South Carolina, Georgia and Florida. Combined, these states constitute a land mass half again as large as California but house almost three times the number of 4(c)8 offices, 1,447 offices of out-of-state holding companies (27 percent of the total). Indeed, these five states and Pennsylvania, Ohio, Texas and California have been the most attractive for interstate expansion through 4(c)8 subsidiaries and, if we may use this as any indication, will probably be the most attractive targets for interstate bank expansion should the prohibition be removed.

Map 4, again, reveals that most interstate 4(c)8 activity has been consumer finance oriented. Over 83 percent of all interstate 4(c)8 offices in the nine states mentioned above as attractive targets were finance companies. In fact, 93 percent of all 4(c)8 offices in Pennsylvania are finance companies. This may be interpreted as evidence that these states would be especially attractive for consumer-oriented banks.

Map 5 shows a more or less consistent pattern for mortgage banking offices with the exception that Tennessee and Illinois should be added to our list of attractive states.

Footnote 15 lists the number of office locations of all 4(c)8 subsidiaries engaged primarily in offering trust services.<sup>15</sup> Florida is obviously the prime target for such activities—again a consumer or retail-oriented service. Part of this pattern, however, may be due to the relative leniency of restrictions that states place on entry via the trust route. Florida, for example has no restrictions on out-of-state organizations establishing trust companies in the state.

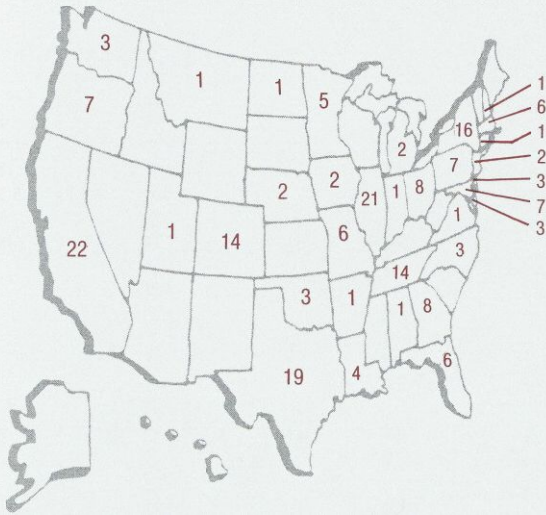
State laws restricting industrial banks also play a part in the geographic distribution of this 4(c)8 activity.<sup>16</sup> Although there is some activity in the Carolinas and Georgia, many states prohibit such organizations. A number of midwestern and western states do allow industrial banks, and that is where most such offices are located.

<sup>15</sup>Trust companies (number of offices in each state) - Florida (20), Arizona (9), Montana (8), North Dakota (6), South Dakota (4), New York (3), Nebraska (2), Pennsylvania (1), Hawaii (1), California (1), Illinois (1), and Tennessee (1).

<sup>16</sup>Industrial Banks (number of offices in each state) - Colorado (40), North Carolina (12), Kansas (12), California (10), Georgia (9), South Carolina (7), Washington (8), Utah (20), Hawaii (2), Arizona (10), Nebraska (1), and Florida (1).

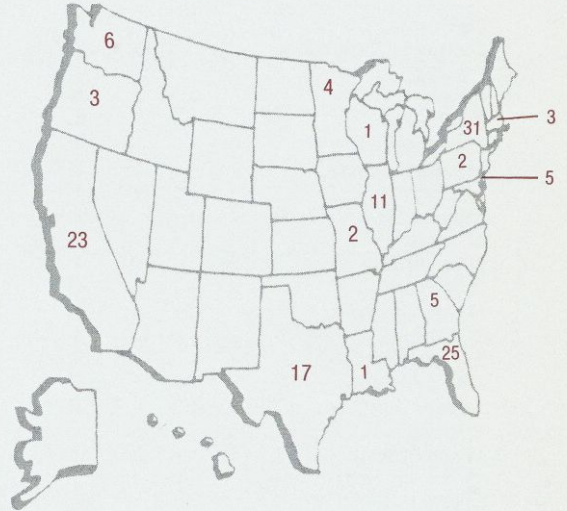


**Map 6**  
Interstate Loan Production Offices  
Located in each State



Total: 202

**Map 7**  
Interstate Edge Act Office Domestic Banking  
Organization



Source: Federal Reserve Bank of New York  
(As of Oct. 1982)

Total: 143

To the extent that offices primarily engaged in the leasing activity may be used to indicate the wholesale banking function, it appears that California, Texas and Ohio will be prime targets for wholesale banking should the laws permit. Each of these states houses at least 10 offices of out-of-state bank holding companies' 4(c)8 subsidiaries. North Carolina, Illinois Missouri and Florida also would appear to be desirable targets from this perspective.<sup>17</sup>

### Other Nonbank Subsidiaries

In addition to 4(c)8 subsidiaries, banking organizations are permitted to establish loan production offices and Edge Act corporations on an interstate basis. Loan production offices can do little more than a calling officer, but they are useful in establishing a wholesale presence in an area. Edge Act offices are also aimed at wholesale customers but are limited to dealing with organizations engaged in international trade.

Since regulatory agencies do not track data on loan production offices, it was necessary to survey banking organizations directly. Only the largest banking organizations are likely to commit resources to loan production offices, especially in light of the fact that calling officers may provide the same services without a physical presence in an area. Therefore we surveyed the top 200 banking organizations in the country and found that they controlled a total of 202 loan production offices.

Table 7 shows the number of banking organizations in each state that have established out-of-state loan production offices, the number of offices established and the number of states in which these offices have been placed. Map 6 shows that California, Illinois, Texas, New York, Colorado and Tennessee have attracted more loan production offices than other states.

Following the same logic, Edge Act corporations are established in order to follow the geographic distribution of one's customers engaged in international trade. There are 143 interstate

<sup>17</sup>Leasing activities (number of offices in each state) - Texas (11), California (10), Ohio (10), Illinois (8), North Carolina (8), New Jersey (5), Missouri (5), Florida (5), New York (4), Colorado, Michigan, Kentucky, Tennessee,

Pennsylvania (3 each), Delaware, Washington, Minnesota (2 each), Montana, Arizona, New Mexico, Nebraska, Louisiana, Georgia, South Carolina, Connecticut (1 each).



**Table 7. Interstate Loan Production Offices**

Parent State	Number of Organizations Establishing Loan Production Offices	Number of Interstate Loan Production Offices Maintained	Number of States Entered by LPO's
California	5	36 <sup>a</sup>	14
District of Columbia	1	7	7
Florida	1	1	1
Illinois	4	31	13
Kentucky	2	8	7
Maryland	1	3	3
Massachusetts	3	14	12
Michigan	1	1	1
Minnesota	2	5	5
Missouri	2	22 <sup>b</sup>	6
New Jersey	1	2	2
New York	8	31 <sup>c</sup>	13
North Carolina	2	4	2
Oklahoma	1	1	1
Pennsylvania	2	4	2
Rhode Island	2	6	5
Texas	2	5	3
Virginia	2	12	5
Washington	2	9	7
<b>TOTAL</b>	<b>44</b>	<b>202</b>	<b>34</b>

**Notes:**

- <sup>a</sup> Only 3 LPOs from California are in New York  
<sup>b</sup> General Bancshares Corporation of St. Louis, MO has full service banks in Missouri, Illinois, and Tennessee. They have 13 LPOs in Tennessee and 4 LPOs in Illinois.  
<sup>c</sup> 10 of the 31 are in California

Source: FRB—Atlanta Survey of Largest 200 Banking Organizations; data as of December 31, 1982.

Edge Act offices of domestic organizations located in the United States. Map 7 shows their geographic distribution. Predictably, states with international trade centers have attracted the most Edge Act offices. New York attracted the largest number, 31, closely followed by Florida with 25 offices. California follows with 23, Texas with 17 and Illinois is a distant fifth with 11 Edge Act offices. New York, Florida, California and Texas are prime targets for this type of wholesale banking. Since only the largest banks may offer services needed by international corporations, banking organizations in the money centers have already located offices to serve these needs. For example, New York banks have established 15 Edge Act offices in California and California organizations have established five such offices in New York. Interstate banking would allow these organizations to provide little more wholesale services than they are providing today.

## Summary of Interstate Activity

Table 8 summarizes by state the number of interstate offices of out-of-state banking organizations. The most impressive aspect is the fact that domestic banking organizations control at least 7,383 interstate offices and, if we include interstate offices of foreign banking organizations, the total reaches 7,840. This compares to a total of 55,440 banking offices in the nation. Almost 1,500 of the identified interstate offices supply all banking services. The remaining offices are nonbank subsidiaries offering a more limited number of banking type services. The sheer number of interstate offices controlled by holding companies is impressive, given the prohibition on interstate banking.

Holding companies may use a number of avenues to serve both interstate retail and wholesale customers. The only area in which they cannot effectively compete for consumer accounts is in the convenience area—providing



**Table 8. Summary of Interstate Activity**

LOCATION	GRANDFATHERED			FOREIGN*			FOREIGN BANKS			States* With Reciprocal Agreement	Preferred* Stock Deals Filed With Board	Interstate* S&Ls	Offices of 4(c) 8 Subs	Loan Production Offices	Edge Act Corporations	Total Offices per State
	Holding* Companies	Banks	Branches	Holding* Companies	Banks	Branches	Agency	Edge	Branch							
Alabama										✓	1	1	107	1		108
Alaska													4	1		5
Arizona	1	1	161										159			321
Arkansas				8	8	148	63	2	2			2	3	22	23	3
California												1	158	14		182
Colorado	1	3	7								1		64	1		65
Connecticut													27	3		87
Delaware	12	12	40							○		2	2	3	5	6
District of Columbia							22	6	1			1	7	6	25	621
Florida	2	2	188				10			□	1	2	253	8	5	276
Georgia							2					2	39			57
Hawaii				1	1	15						1	47			156
Idaho	2	2	107										1			100
Illinois	1	3	4	1	1	1		3	36	□		1	132	21	11	212
Indiana													99	1		100
Indiana	1	11	50							□	1		42	2		105
Iowa												1	78			78
Kansas												1	61			61
Kentucky							1						164	4	1	170
Louisiana										✓	1	2	1	7		1
Maine	1	2	30							✓	2	1	82	7		121
Maryland									4		2	1	68	6	3	81
Massachusetts													56	2		58
Michigan											1		34	5	4	43
Minnesota													89			89
Mississippi												1	75	6	2	83
Missouri												2	28	1		102
Montana	3	25	48										28	2		74
Nebraska	1	5	39										21	2		88
Nevada	1	1	66									1	20	1		21
New Hampshire													110	2		112
New Jersey													44			84
New Mexico	1	5	35										156	16	31	331
New York	1	2	27	3	3	39	18	2	37	✓	4	3	367	3		370
North Carolina													23	1		168
North Dakota	3	34	110										310	8	4	322
Ohio											2		76	3		79
Oklahoma											1		83	7	3	270
Oregon	1	1	169									4	320	7	2	335
Pennsylvania											2		13			13
Rhode Island													229			229
South Carolina											1		16			108
South Dakota	3	12	80							○			159	14		202
Tennessee	2	2	27										289	19	17	334
Texas								9			1	5	37	1		74
Utah	1	1	35							✓		1	4			4
Vermont													227	1		297
Virginia	1	6	63									2	114	3	6	219
Washington	1	1	85						10				40			40
West Virginia													39		1	68
Wisconsin	3	6	22										10			18
Wyoming	2	4	4									1				
TOTALS	45	141	1,397	13	13	203	116	22	103	10	20	45	5,500	202	143	7,840

**Notes:**

- - These states allow entry of limited-purpose banks
- - These states allow expansion of interstate grandfathered banks
- \* - These columns are not included in total number of offices
- A - Six of the foreign bank holding companies own only one bank, but the bank is located outside the home state of the foreign banking organization.



brick-and-mortar offices to attract small and medium sized consumer accounts.

On the wholesale side, holding companies are providing a wide array of interstate financial services, some of which require a physical presence but many of which do not. Many of these corporate services may be provided through nonbank subsidiaries, which are free to establish interstate offices. In addition, large banking organizations are providing large corporate customers with banking services not requiring physical interstate offices. These banking organizations appear to be competitively handicapped only in providing certain wholesale banking services to medium and especially small business customers. These customers still depend to a large extent on locally controlled banks.<sup>18</sup>

It appears, however, that as time goes by more and more of the financial services required by medium and small businesses will be targets for large banking organizations supplying these services through 4(c)8 provisions. It simply is not necessary for a banking organization to maintain a facility that both accepts deposits and makes loans to be competitive across state lines. The larger holding companies have already established their nonbank interstate presence.

Some of the smaller banking organizations having a regional scope are moving quickly to establish formal and informal agreements to form interstate networks if the interstate prohibitions are removed. Their rationale seems to be a perceived need to become large enough to compete with the money center banks on an equal footing. Although the smaller banking organizations make the assumption, the question is whether larger banking organizations are under any strong pressure to establish a nationwide interstate banking network involving brick-and-mortar offices. The answer must be a modified no.

First, the removal of Regulation Q means that banks will be required to pay money market rates for a larger proportion of their small and medium size deposits. The day of bank deposit customers subsidizing banks through low interest is over. Take this subsidy away and add in the

expense of operating distant offices and one conclusion is clear: large banks have no great incentive to use brick and mortar facilities to collect deposits except possibly in the most attractive high growth markets.

From the consumer's standpoint the idea of interstate networks is also questionable. As banks are required to pay money market rates for more of their funds, they necessarily will have to pass the costs along to consumers through direct pricing on services. Since an interstate banking network will be expensive to maintain, will customers be willing to pay for the marginal benefits associated with "unlimited" geographic access to their accounts? The answer is probably "no," given the number of less costly alternatives available that do not require an interstate network. For these reasons it does not appear that the consumer will lead the way to interstate banking. Supply in this case will definitely follow demand—and little demand exists for this type of service.

Too many avenues allow banking organizations to provide interstate financial services on a less costly basis to believe that nationwide interstate brick-and-mortar expansion is inevitable.

Interstate bank expansion will occur in the absence of the interstate prohibition, but, because of the prodigious amount of interstate activity already in place, it will evolve slowly and will be geographically limited to the more attractive markets. There is some danger that small and medium sized banking organizations might be panicked into building interstate banking systems large enough to fend off money center banks. In the short run this may create some inefficient organizations. Taking a longer view, however, market forces will correct these inefficiencies. The larger money center banks, on the other hand, quite obviously will become active in the more attractive markets—but are unlikely to establish comprehensive nationwide interstate networks because they have already established themselves through nonbank subsidiaries.

—David D. Whitehead

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<sup>18</sup>David Whitehead, "Sixth District Survey of Small Business Credit," *Economic Review* Federal Reserve Bank of Atlanta (April 1982), pp. 42-48.





# The Financial Conglomerates

An important development in the financial services industry is the formation of financial conglomerates offering a wide range of services from one source. While the potential impact of these conglomerates is huge, little evidence exists about whether synergy on such a large scale can really work in the financial services business. Can the diverse parts of these financial service conglomerates mesh and complement each other, leading to increased sales and reduced costs related to consolidation?

Some evidence suggests that it will be difficult to achieve these synergies, at least in the short run. Previous attempts to create synergy in the financial services industry have been somewhat disappointing. For the most part, life insurance sales by stock brokerage firms and mutual savings banks have not been a roaring success. Continental Insurance made little progress toward the synergy that was supposed to accrue from its Diners Club credit card operation or its consumer finance subsidiary (both units have been sold), while INA was never able to sell insurance through its Blyth Eastman Dillion subsidiary.

Of course, significant cross-selling opportunities can accrue to financial conglomerates as well as increased opportunities for mass marketing of additional services. There are also opportunities to eventually consolidate operations and utilize available computer capacity. However, it may take years to effectively achieve these synergies.

Nevertheless, the trend toward financial conglomeration is real and likely to continue in the future as witnessed by the large number of non-bank companies that have become significant factors in the financial services business.<sup>1</sup>

<sup>1</sup>Alan Gart, "The Future of the Financial Services Industry," National Association of Business Economists, Jacksonville, Florida, October 19, 1979.

The potential impact of "near-banks," such as Sears, American Express and Merrill Lynch, on the financial markets is enormous. Banks and savings and loan associations are constrained by networks of Depression-era regulations that prevent them from branching across state lines, shut the door on domestic investment banking and sharply limit subsidiary activity. Near-banks, on the other hand, are scarcely touched by such rules because they do not accept deposits. They are less restricted as to the business functions they can perform and the business locations they can choose.

Let's look at some examples of financial conglomerates and examine their strengths, weaknesses, and likely evolution.

## Merrill Lynch

Although Merrill Lynch is best known as a retail stock brokerage firm, it performs a complete array of investment banking services. Its Capital Market Group is actively engaged in merchant banking, institutional sales, trading, arbitrage, block positioning, and underwriting.

The greatest growth at Merrill Lynch has come in its retail or consumer activities. Its money market funds and Cash Management Account (CMA) have attracted a plethora of new customers that offer the potential to become retail brokerage customers. The CMA combines a securities account, a money market fund, a VISA debit card, and access to liquidity through a credit card, or checking account arrangement via Banc One of Columbus, Ohio. The company also offers credit cards to its retail customers.

Merrill Lynch has also begun to sell insurance through its brokers in close to 500 domestic offices.

*Nonbank financial conglomerates, relatively unhindered by regulations, are expanding in size and scope. If deregulation continues, financial conglomerates that offer all financial services could emerge.*



The company has become active in selling tax shelters, commodity services and CDs (for Banc One of Columbus and Home Federal Savings and Loan of San Diego from whom they receive a commission).

The company also has an active real estate subsidiary that offers to buy and sell homes and commercial properties. All these services appear to be part of a corporate plan for Merrill to become a complete financial supermarket for investors.

## The New Sears

Sears Roebuck, in one sense, is even more of a financial supermarket than Merrill Lynch. Through Allstate, its property, casualty, and life insurance subsidiary; Dean Witter; Coldwell Banker; its ownership of the eleventh largest savings and loan association in California with \$3 billion in assets and a small commercial bank in Chicago; its nearly 4000 outlets in department stores and catalog offices; a new check processing service to be offered in conjunction with credit unions; and its base of 25 million active credit card holders, Sears may well be a model of future banking concerns.

The Chicago-based Sears has a huge in-house data base on consumer credit which will become the nucleus for the carefully targeted selling of loans, money market funds, stocks, and other instruments. A recent Roper organization poll found Sears to be "viewed most favorably" by consumers who rated it against other corporations. This acceptance should offer Sears an edge over competitive financial institutions. Sears seems ready to launch an array of additional services that may include:

- The formation of a world trading company.
- The provision of retirement account opportunities for its customers.
- A debit card that could be used to endow the new money market fund accounts with savings and checking account privileges.
- A universal financial card capable of handling practically all household financial transactions.
- A move into secured and unsecured personal lending including homeowners' loans that should rival finance companies, banks, and thrifts.
- A pioneering system in two-way communications with the home through computers and telephone for financial and consumer product transactions.

- A national hookup of automated teller machines (ATMs) in Sears retail stores that could hook up to bank-like Sears merchandise credit accounts, allowing customers to draw cash, take small personal loans through prearranged lines of credit, deposit money, or make merchandise, mortgage, insurance premium, or stock purchase payments. Through agreements that Sears could make with certain banks, customers of those banks could use ATMs at Sears stores to tap their savings or checking accounts or even to pay bills.

Although the potential for cross-selling and the introduction of these new products seem quite promising, there are some potential pitfalls.<sup>2</sup> As the company pushes more direct selling of merchandise and financial services, notably through interactive television and home computer systems, it may steal sales from its own stores.

## American Express

The next financial services giant, American Express Company, faces a huge challenge in successfully integrating the securities firm of Shearson Loeb Rhoades, Inc., (acquired in a \$1 billion stock swap) into its financial empire. This financial conglomerate with a holding company at the top is best known for its travel service and credit card business. Among its major assets are a giant-sized international bank, Warner Amex Cable Communications, Fireman's Fund Insurance, and Mitchell Beazly Ltd. (a publishing company). It has also purchased a 10 percent interest in McLeon Young Weir Ltd., a major Canadian securities firm. Shearson has also purchased Foster & Marshall, one of the largest regional brokerage firms in the Northwest, and Robinson-Humphrey, a major regional brokerage house in Atlanta.

American Express is moving beyond travel and leisure dollars to vie for a central role in the money that Americans save and invest. The company is counting on two salient aspects of its business: its reach into the affluent sector of the economy through its 13 million cardholders whom it views as nearly recession-proof and through its data processing ability and information systems. The company wishes to become an omnipresent intermediary for affluent Americans, tapping into the estimated \$8 trillion of personal assets in the United States.

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<sup>2</sup>Business Week, November 16, 1981.



In addition to its credit card base of customers, American Express can also reach affluent Americans through more than 4,000 brokers in its Shearson system.

The company is presently gearing up for the first offspring of the Shearson American Express marriage, a computerized cash management service called the Financial Management Account (FMA) which permits credit card and checking withdrawals from an investment account.

Another kicker is the potential tie-in with Warner Amex Cable Communications, which would put American Express in the forefront of electronic consumer financial transactions on their television screens. The company is exploring other sophisticated interactive home services such as electronic banking and shopping and commercial services for business.

## Conclusion

The examples of Sears, Merrill Lynch, and American Express suggest what might lie ahead for the financial services industry.<sup>3</sup> With a loosening of regulation, financial conglomerates that offer all financial services nationwide could emerge. The current regulations separating insurance companies, banks and consumer finance and investment brokerages are fading, laying the foundation for the future. The real questions that must be answered are whether American consumers will really be attracted by one-stop shopping for all their financial needs and whether the environment is truly different today so that hybrid financial products and cross-selling across subsidiaries can really work in the 1980s. Recently, the advertising of financial services seems to encourage consumers to be selective, to pick and choose the best investment or vendor of services to fit a particular need. Also, the popularity

of financial supermarkets is being tested in the marketplace. A lot of careful planning will be necessary in order for the sum of the parts to add to more than the sum of separate entities.

Banks in this country have been handicapped by both product and geographic regulatory constraints. Although the bank holding company umbrella permits some flexibility, banks (for the most part) cannot branch across state lines, underwrite corporate securities and some forms of municipal revenue bonds, or sell non-credit related insurance. On the other hand, most European banks and American financial conglomerates do not have these product or geographical limitations.

With the recent networking of nationwide ATMs and the acquisition by New York based Citicorp of a troubled California thrift institution, it is highly likely that some of the restrictive regulatory barriers may fall within the next few years. Some states and regions, such as New England, are already considering reciprocal branch banking facilities. Restrictive geographic banking regulations seem rather arbitrary and inconvenient to consumers in a modern computer and communications era where people commute from New Jersey and Connecticut to New York or from Virginia and Maryland to Washington, D.C. in order to go to work.

If some form of regional banking is permitted in the next couple of years, unlimited interstate banking would probably follow by the end of the decade. Removal of the geographic constraint would place banks in a better position in competing with financial conglomerates for the retail financial services of consumers.

—Alan Gart

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<sup>3</sup> For a more complete inventory of nonbanking institutions' financial services, see C. Westbrook Murphy and Thomas W. Brunner, "Will Anyone Try to Block Amexco?" *American Banker* April 23, 1981, and Harvey Rosenblum and Diane Siegel, "Competition in Financial Services: The Impact of Nonbank Entry," Federal Reserve Bank of Chicago, 1982.





## Regional Forces for Interstate Banking

*With nonbank financial conglomerates spreading their presence nationwide, interstate restrictions on banks may be harming the very institutions they were designed to protect.*

Market forces are changing the structure of banking and the financial service industry.<sup>1</sup> Financial innovations such as the spread of NOW accounts and similar interest bearing transaction accounts and the growth of money market funds served as catalysts. Together with the thrift industry crisis, they helped bring on the Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982. Among other things, this legislation finally provided for the phaseout of Regulation Q.<sup>2</sup>

Similar innovations and market pressures are forcing bankers, legislators and regulators to reassess the desirability of maintaining geographical restrictions on intrastate and interstate banking. This article dissects these market developments and explains why it may not be possible, or desirable, to maintain for long the existing limitations on branching and bank holding company expansion. It also will look at some of the public policy issues that will arise as these restrictions are re-examined.

### How Banking Organizations Erode Interstate Restrictions

Notwithstanding the 1927 McFadden Act prohibitions on interstate branching, banking organizations were very successful during the late 1960s and early 1970s in innovating methods to establish physical presences across state lines.<sup>3</sup> Banks have employed loan production offices, Edge Act Corporations, corporate calling officers, and EFT facilities.<sup>4</sup> Larger banks have adopted

<sup>1</sup>See for example Kane (1982) or Eisenbeis (1981b).

<sup>2</sup>For a description of these Acts see McNeill and Rechter (1980).

<sup>3</sup>See for example Eisenbeis (1980), Whitehead (1983), Department of the Treasury (1981), Peter Merrill Associates (1981) and Golembe Associates (1979).

<sup>4</sup>There are now over 100 shared and proprietary EFT systems that allow a customer to obtain cash by drawing down funds in an account across state lines.



the bank holding company form to facilitate the operation of nonbanking subsidiaries, such as consumer finance companies, industrial banks, mortgage banking firms and trust companies throughout the country.<sup>5</sup>

Similarly, many key classes of customers—and especially large corporate customers—have found it profitable to incur the search and transactions costs to deal with nonlocally based suppliers of financial services. Large business loans have long been negotiated in national and international markets, and the establishment of such a corporate relationship has usually resulted in deposit balances flowing into the nonlocal market as well.

To a large extent then, the prohibitions on intra and interstate banking have become progressively eroded. But it is also significant to note that, except for the largest customers, most of these innovations have effected the lending activities of banking organizations. The principal area that has remained less affected by these banking innovations has been retail deposit taking. Thus, the main consequence of existing intra and interstate banking restrictions has been to insulate retail deposit markets from nonlocal competition.

### **Interstate Expansion by Unregulated Competitors**

In the late 1970s and early 1980s the combination of extremely high interest rates and binding Regulation Q ceilings stimulated the entry of unregulated nondepository institutions into the financial service industry. These firms have innovated ways both to take retail deposits across local markets and on an interstate basis at near market rates and to offer a wide range of financial, investment and insurance services not available from commercial banks. Both of these activities are perceived as actual and potential threats to banking organizations.

The principal innovation that has evolved to collect consumer deposits on an interstate and national basis has been the money market mutual fund. At the time of the Garn-St Germain Depository Institutions Act of 1982, noninstitutional deposits in these funds approached \$183 billion or about 15% of bank and thrift institutions' small time and savings deposits. The real importance of money market mutual funds is that they have broken down the dependence of previously locally limited customers on local depository institutions for financial services. The rapid growth of these funds during the late 70s and early 80s indicated that, when the opportunity costs to consumers resulting from regulatory constraints are sufficiently high (1) to overcome the inconvenience and search costs associated with seeking higher rate alternatives, (2) to breakdown their resistance to dealing with nonlocal institutions, and (3) to compensate for holding a greater portion of their financial assets in the form of uninsured liabilities, consumers will shift their funds into alternative investment instruments.<sup>6</sup>

As distinct from the market supply oriented methods banks have developed to avoid restrictions on interstate banking, the growth of money market mutual funds has affected the structure of both the market demand and supply for deposit funds. Clearly, the funds increased the number of alternative suppliers of deposit-type services offering near money market rates. In addition, it has already been suggested that their growth and customer acceptance signals a fundamental change in the nature of the demand for deposit and other financial services. Once customers are no longer dependent on local sources of supply for deposit services, the geographic market ceases to be local; and in this case it has become an interstate market. Under these circumstances, any benefits that might have accrued previously to in-state banks from prohibitions on intra or

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<sup>5</sup>Even the subsequent authorization of the \$2500 minimum deposit Super NOW accounts and the MMDA December 14th account, both free of interest rate ceilings, did not reduce the importance of money market funds. To be sure the phenomenal growth of these two new accounts to over \$290 billion (as of February 16, 1983) in a very short period suggests that, *ceteris paribus*, consumers prefer insured to uninsured accounts. However, only \$10 billion of these funds probably came from money market funds, which still stand at \$204.6 billion.

<sup>6</sup>Not discussed in this section are the implications of the 24 interstate supervisory mergers of S&L's. During 1982 and 1983, 24 interstate

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consolidations were approved (involving many more than 24 S&L because of multiple acquisitions in a single application). This includes the acquisition by Citicorp of a failing S&L in California. These acquisitions have created a number of interstate S&L's, but the competitive significance will depend upon whether the industry weathers its financial crisis. Also not discussed is the potential expansion of single S&L holding companies which are not subject to as stringent limitations on permissibly nonbanking activities as are multiple S&L holding companies and bank holding companies. (For a further discussion see Federal Reserve (1981).



interstate banking —by protecting local deposit markets from actual entry or the threat of entry by out-of-state banks—are completed dissipated.

Three other recent interrelated financial innovations should serve further to bring the efficacy of existing interstate banking restrictions into question. Two of these innovations evolved in direct response to binding Regulation Q ceilings (and to a lesser extent, reserve requirements) on banks and thrifts; they attempt to capitalize further on the breakdown in consumer dependence on local depository institutions.<sup>7</sup> The first is the evolution of symbiotic finance, and the second is the emergence of the new broker-bankers. The third innovation relates to the potential exploitation of the nonbank-bank device by both brokerage firms and non-financial firms to avoid the nonbanking (and interstate) activity restrictions in the Bank Holding Company Act.

### Symbiotic Finance

Symbiotic finance is simply the joining together of independent firms to provide services that the participants could not legally or economically provide individually (See Eisenbeis 1981a). The classic example is the Merrill Lynch Cash Management Account, which combines a margin account at a brokerage firm, a captive money market mutual fund, a Visa debt card, and a servicing arrangement through BancOne of Ohio. Variants and refinements of this service are being offered by numerous other brokerage firms. In addition, Visa has also authorized a money market fund directly to use its debit card issuance through a Boston bank thereby eliminating the need for a margin account from a brokerage firm.<sup>8</sup>

These nonbank symbiotic finance arrangements have enabled nonbanking firms to offer often superior substitutes for traditional banking services and thus pose a significant potential competitive threat to banking organizations.<sup>9</sup> Not only do they capitalize on the fact that

consumers have learned they can obtain financial services from nonlocal and nontraditional firms, but also some of these firms have an extensive interstate presence which could serve as additional consumer service centers.

### The Growth of the Broker-Bankers

In fact, the incentives for certain firms to diversify into the banking business have been so strong that a wave of vertical combinations was precipitated in 1982 in the brokerage business. The result has been the second of the three financial innovations mentioned previously—the creation of the broker-bankers. Recent combinations of American Express-Shearson, Bache-Prudential and Sears-Dean Witter-Coldwell Banker, just to name a few, have resulted in a whole new class of financial service firms.<sup>9, 10</sup> These firms are internalizing certain symbiotic financial arrangements to take advantage of potential synergistic or scope economies. To this extent, they represent an intensification of symbiotic relationships. For example, Shearson-American Express is employing an American Express Credit Card in connection with a Shearson Cash Management

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*“These . . . arrangements have enabled nonbanking firms to offer often superior substitutes for traditional banking services.”*

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Account. The chief difference from the Merrill Lynch-Visa type cash management account, which requires an immediate debit to the margin account, is that under the American Express arrangement, balances to the credit card account can be paid out of the margin account at the end of the monthly billing cycle.

However, the broker-bankers are also positioning themselves to offer a wide range of

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<sup>7</sup>Unlike the Merrill Lynch Account, which has a \$20,000 minimum initial deposit, this account would have only a \$5,000 minimum initial balance.

<sup>8</sup>Recently, Merrill Lynch has announced a link with a Japanese broker and a Swiss merchant bank to offer a mutual fund to its retail customers specializing in investments on a world wide basis in scientific and

technological firms.

<sup>9</sup>For a detailed listing of such combinations see Rosenblum and Siegel (1982).

<sup>10</sup>Sears has most recently announced its intention to use its Sears World Trade, Inc., subsidiary to market financial services worldwide.



consumer and corporate financial, brokerage and insurance services. Thus the potential competitive threat of these unregulated broker-bankers and other unregulated competitors spreads far beyond their immediate activities with money market mutual funds and cash management accounts. These institutions presently operate offices interstate and are not subject to bank regulation. Furthermore, some are already positioned to expand into the electronic transaction business. Shearson-American Express, for example, has a partial interest in Warner Communications, the nation's largest cable TV firm. Warner has an experimental in-home interactive network that could be adapted to provide transactions and related financial services. Combined with its satellite communications capabilities, American Express has the real potential to put together a worldwide on-line payments system. What is unique about this arrangement is that, like the merchants such as Sears, Wards and Penneys, who have substantial on-line POS capabilities, collateral uses of the hardware and other aspects of the system allow costs to be spread. Such a network would not be dependent solely on fees and transaction charges for payments services to make the system profitable, as is presently the case with bank-operated electronic payments services. To spread their costs, banks have entered into joint venture, sharing, and franchise arrangements with other banks.

Merchants and broker-bankers are not the only firms creeping into the banking transaction business. The credit card companies, which have enjoyed a symbiotic relationship with banks, have also begun to expand into payments area. Not only do Visa and Master Card now have debit cards, but also both have announced plans to establish nationwide ATM networks to serve participating firms and their customers

Unlike the money market mutual funds and the credit card companies, broker-bankers have not yet made significant inroads into the consumer financial service business. But the combination of technology, widespread geographic presence, and cost and regulatory advantage suggests that broker-bankers and others could be a potential competitive force for existing depository institutions. Moreover, their targeting of the middle and upper income consumer<sup>11</sup> and their ability to offer an attractive and flexible package of services suggest that such

unregulated competition could make considerable progress in attracting away a very profitable portion of the commercial bank consumer customer base.

## Nonbank Banks

The third recent financial innovation that heightens the interstate competitive threat to commercial banks has been the recent wave of acquisitions of nonbank banks by money market mutual fund organizations, such as Dreyfus; by conglomerates, such as Gulf and Western, Wilshire Oil and Parker Pen Company; by merchants, such as McMahan Valley Stores; and by finance companies, such as Teachers Service Organization, Avco Financial Services, Beneficial Corporation and Household Finance Corporation. The acquired nonbank banks are chartered commercial banks which do not both make commercial loans and accept demand deposits. Such banks do not meet the statutory definition of a bank for purposes of the Bank Holding Company Act, and hence their acquisition by a nonbanking firm does not cause that firm to become a bank holding company.<sup>12</sup> Since the acquisition of nonbank banks is not governed by the Bank Holding Act, they may be acquired by any financial or nonfinancial company. Furthermore, nonbank banks can be acquired in any of several states to form an interstate organization without regard to the Douglas Amendment restrictions on interstate banking operations.<sup>13</sup> Because of this potential for linking brokerage, commercial and industrial activities with interstate deposit taking, the expansion of nonbank bank acquisitions should be perceived as a real competitive concern to banks under the present regulatory system.

Should the nonbank bank activity prove to be a successful way to avoid bank holding company regulation, then it seems only a matter of time before major banking organizations would subdivide their existing banks into sets

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<sup>11</sup>See Gross (1981) and Murphy and Brunner (1981).

<sup>12</sup>Acquisition of more than 10% of such a bank's stock must still be approved by the appropriate federal bank regulator under the Change in Bank Control Act. To date such approvals have been given by both the FDIC and the Comptroller of the Currency.

<sup>13</sup>Of course, such banks would still be prohibited by the McFadden Act from branching interstate.



of nonbank banks and thereby cease to be bank holding companies.

## Implications of Innovations to Avoid Interstate Banking Prohibitions

Several important observations emerge from the recent surge of financial innovations to avoid branching constraints. First, as David Whitehead (1983) demonstrates, significant interstate banking already exists. Both banks and nondepository institutions have evolved numerous ways to supply bank-type services across state boundaries to nearly all significant classes of customers, except with respect to retail deposit-taking.

Second, the unexploited potential of the broker bankers and the nonbank banks suggests that further expansion of nontraditional suppliers into the banking business is extremely likely. Third, the growth of money market mutual funds—and to a lesser extent cash management type accounts—indicates that even significant groups of consumers no longer are limited to local markets for many financial services. This change in the geographic scope of consumer demand, together with the non-local nature of many business financial markets and devices that have evolved to avoid interstate banking restrictions, suggests that those limitations are becoming increasingly anachronistic. Fourth, the main parties adversely affected by restrictions on geographic expansion are commercial banks, forced to compete with institutions not subject to the same restraints. Existing limitations no longer are protecting banks from outside competition. Instead, they are preventing banks from following their customers or attracting new customers over the same geographic range as competitors. Finally, for banks preferring consolidation to independent status, limitations on interstate banking restrict the number of outside bidders and thus reduce the price shareholders can realize by selling

out. We may conclude that interstate restrictions are harming the very institutions they were designed to protect.

## Changing Attitudes

Responding to the changing environment, a few states, including Illinois, Florida, Nebraska, and Arkansas, have recently liberalized their policies toward intrastate expansion. More importantly, six states have also enacted legislation allowing out-of-state banking organizations to enter.<sup>14, 15</sup>

These six states may be divided roughly into two categories based on the type of outside entry they permit (see Table 1). South Dakota

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*“Broker-bankers...could be a potential competitive force for existing depository institutions.”*

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and Delaware allow out-of-state bank holding companies to acquire only single-office, limited-purpose banks.<sup>16</sup> Both states specify minimum initial capital requirements of \$10 million. These limited-purpose banks must employ at least 100 employees. Additional restrictions prevent these institutions from conducting general purpose banking that might pose a competitive threat to indigenous banks. These two states are attractive to outside bank holding companies because of favorable usury ceilings and liberal tax laws. Those advantages encouraged banking organizations from New York and Pennsylvania to relocate their credit card operations and certain other activities.

The other four states, Alaska, Maine, Massachusetts, and New York, place no special limitations on the kinds of banking business that may be done. But these states restrict either the type of entry or the locations of firms seeking entry. For example, Alaska prohibits

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<sup>14</sup>Often, Iowa and Florida are cited as permitting out-of-state holding companies to acquire in-state banks. But in both instances, the applicable statutes merely grandfathered existing out-of-state operations. Only one bank holding company in Iowa and a couple in Florida are affected. In both instances, however, the grandfathered companies have expanded through additional acquisitions. From 1981 through March 18, 1983, Utah allowed reciprocal acquisitions by any bank holding company resident in a state with such reciprocal provisions. In April, Washington

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passed legislation to facilitate Bank of America's acquisition of Sea First.  
<sup>15</sup>The Douglas Amendment to the Bank Holding Company Act of 1956 prohibits interstate acquisitions of banks unless the acquired bank's state has explicitly enacted legislation permitting such acquisitions.

<sup>16</sup>South Dakota recently passed legislation permitting banks to engage in insurance activities that they would be prohibited from engaging in through subsidiaries of bank holding companies. This will kindle additional interest in outside entry by banking organizations into South Dakota.



**Table 1. States Permitting Outside Entry by Banking Organizations\***

Alaska -	Permits acquisition of existing banks by out-of-state bank holding companies. The acquired banks must have been in existence for at least three years; thus, <b>de novo</b> entry is not feasible.
Delaware -	Allows acquisition of a single office, limited purpose, <b>de novo</b> bank with an initial capitalization of \$10 million. At least 100 employees must be hired. Competition with indigenous banks must be minimal.
Maine -	Allows acquisitions by out-of-state bank holding companies on a reciprocal basis.
New York -	Similar to Maine.
South Dakota -	Similar to Delaware
Massachusetts -	Allows reciprocal bank holding company acquisitions and branching in New England only.

\*Iowa and Illinois allow expansion by companies with bank or trust company subsidiaries grandfathered by the 1956 Bank Holding Company Act. Florida law provides an exception to the general prohibition for any out-of-state holding company which on Dec. 20, 1972 owned all the assets of, or had control over, a Florida bank or trust company.

Source: **Bank Expansion Reporter**, January 3, 1983.

the acquisition of *de novo* banks and requires that outsiders gain entry by acquiring banks that have been in existence at least three years. Maine and New York permit acquisitions by bank holding companies from states with reciprocal legislation permitting entry by Maine or New York holding companies, respectively, and Connecticut has similar legislation pending. Massachusetts, the most recent to permit outside entry, has a similar reciprocal clause but only for bank holding companies headquartered in other New England states. This limitation of entry to institutions from particular geographic areas may be symptomatic of a growing trend toward cooperative regional approaches to relaxing interstate restrictions.

Reports in the financial press (see Forde, 1983) of a February meeting among New England bankers, regulators and legislators indicate a growing consensus that, because of the integrated nature of those states' economies, some form of regional interstate banking experiment may have merit. Participants expressed a desire to coordinate the effort since "all the New England legislatures were expected to consider, or reconsider," interstate banking issues this year. These same reports, however, also imply that many participants want to avoid changes that would affect local banks adversely or would divert funds out of the area.

Most recently Senator Tsongas and Representative Frank, both from Massachusetts, have introduced federal legislation that effectively would acknowledge the experiment in interstate banking in New England. Our analysis suggests that reciprocal approaches to interstate banking reflect the overly optimistic views of bankers that interstate branching laws can still afford some degree of protection from interstate competitors.<sup>17</sup>

In the Southeast, the Southern Growth Policies Board, as part of a broader program to foster economic development in member states, formed the Southern Regional Banking Committee. The committee was charged with recommending to the 12 member states possible changes in the banking structure to improve performance and enhance the ability of southern banks to compete for funds. Committee members proposed the elimination of state usury ceilings, the liberalization of intrastate branching restrictions, and a phased relaxation of limitations on bank holding company expansion. While the committee did suggest a regional, reciprocal

<sup>17</sup>In New England, many still want to exclude the large New York banks from the region. While New York banks can presently expand into Maine, the new Massachusetts law explicitly excludes New York banks from using subsidiaries in Maine to expand into Massachusetts.



approach to holding company expansion, it argued that such agreements should be in place for only a limited time before nationwide agreements could be pursued.<sup>18</sup> To date, however, these recommendations have received little consideration among the Southern Growth Policy states.

## Policy Issues Pertaining to Proposals for Regional Interstate Banking

The Carter administration's report on interstate banking focused on several policy issues raised by modified interstate banking restrictions.<sup>19</sup> These include implications of any proposed changes regarding:

1. The level and quality of services to local communities,
2. The viability of smaller banks,
3. The safety and stability of the system,
4. The division of supervisory and regulatory responsibilities among state and federal authorities,
5. Competition and concentration of resources.

The consequences for the first three areas would be largely unaffected by the various alternative methods proposed for liberalizing branching and interstate bank expansion. For example, research evidence suggests that the quality and quantities of services are generally enhanced whenever multi-office banking is permitted. The availability of credit to locally limited consumers and businesses generally is increased, and no evidence suggests that bank holding companies or branch banks redirect funds from less developed to more developed markets. Notwithstanding the fears of smaller banking organizations, branching or holding company expansion appears to pose no threat to the viability of small banks. Neither is there evidence that large banks can enjoy cost or scale advantages over smaller banks; even in

the most competitive markets, small banks tend to outperform larger competitors.<sup>20, 21</sup>

Finally, safety and soundness considerations suggest that risk may be slightly greater where multi-office banking is permitted, with bank holding company subsidiaries exhibiting slightly greater risk than independent branch banks. The evidence for this is rather tenuous, however, and must be balanced by the advantages that multi-office banking offers in facilitating the takeover of weak or failing institutions.

Proposals to liberalize interstate banking laws can have important effects on regulatory policies and structure and on the division of authority among state and federal agencies. In general, the wider the branching powers of banking organizations, the more difficult it will be for individual states to impose differential regulations on firms operating within their borders or on their own state-chartered banks. Similarly, state banking departments might be hard pressed to examine all their own institutions plus those operating within their boundaries. Most likely, wide geographical expansion would force uniformity of state policies and, because of regulatory burdens, tend to favor national as opposed to state-chartered banks.<sup>22</sup> These problems would be greatly reduced, however, if expansion took place through separately chartered bank holding companies in each state. In that case, the individual states would need to be concerned primarily only with subsidiaries operating within their boundaries.

Perhaps the most controversial area, however, is the effect of liberalized banking on competition and on the concentration of resources. Restrictions on geographic expansion have, in the past, insulated many local markets from competition. On the other hand, concentration in SMSAs tends to be slightly higher in states with more liberal branching laws. Thus, there is the legitimate concern that wide geographic expansion will be accompanied by increased consolidation of the banking system. And this

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<sup>18</sup>"To provide for a greater accumulation of capital, to enhance economic development and to facilitate more effective allocation of financial services to individuals and businesses of all sizes, the SGPB states should enact legislation to permit entry of out-of-state bank holding companies on a reciprocal basis. To allow regional bank holding companies an opportunity to position franchises to compete in national markets, reciprocal banking agreements should be limited to the states of the SGPB region for a specified period of time with provisions for nationwide agreements beyond the limiting interval (See Skinner (1982)."

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<sup>19</sup>See Department of the Treasury (1981).

<sup>20</sup>For a review of the scale economies literature see Benston, Humphrey and Hanweck (1982).

<sup>21</sup>Savage and Rhoades (1981) examined the performance of small banks in major metropolitan markets.

<sup>22</sup>In the extreme, a state chartered bank operating in 50 states might be examined by state banking departments whereas a national bank would only be examined by the comptroller of the currency.



consolidation is likely to take place—as it already has begun in Pennsylvania—by first combining the largest competitors rather than assuring that a large number of more equal sized competitors are formed and then allowed to compete head to head.

The Carter administration expressed fear that antitrust laws and policies may be inadequate to guide the transition from a regional and local banking system to one that permits wide geographic expansion. This concern deserves careful consideration. Regional approaches to liberalizing interstate banking would assure that several larger organizations would compete at the national level. A resulting cost of this approach, however, may be increased concentration of resources and economic power within those regions.<sup>23</sup> This issue suggests that any

interstate banking proposals be given careful consideration.

## Conclusion

Pressures to relax restrictions on interstate banking further are likely to increase rather than abate. Furthermore, many bankers are coming to realize that existing prohibitions are now hurting banks more than they are protecting them from outside competition, and efforts are already afoot in several regions to promote regional relaxation of interstate banking limitations.

Finally, a number of public policy issues arise in proposing changes in the Douglas Amendment and McFadden Act. Those relating to competition and concentration of resources may prove the most critical. Providing a smooth transition to a more geographically diversified banking system while ensuring an adequate level of competition at the local market level constitutes one of the most difficult problems policy makers will face.

—Robert A. Eisenbeis

<sup>23</sup>It was precisely this fear that led one member of the Southern Regional Banking Committee to dissent from the proposals of the SGPB (See Skinner (1982)).

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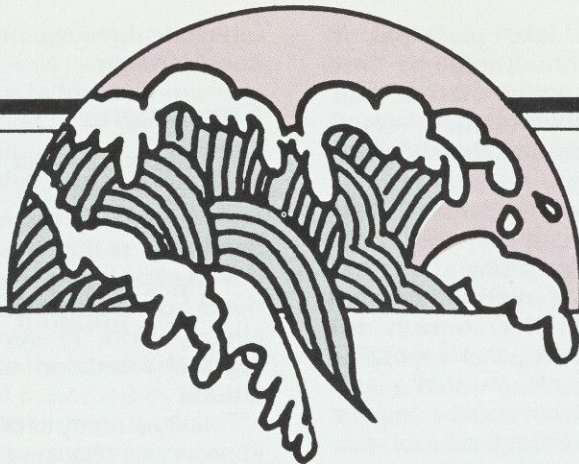
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## Alternative Avenues to Interstate Banking

*Even if legal barriers to interstate activity are removed, other factors will tend to limit interstate holding company activity. The effects on financial institutions and consumers, however, will depend on the exact route interstate banking takes.*

Observers of the U. S. financial scene generally agree that broadened interstate banking activity is coming. We will focus on the *differences* in the impact of interstate banking depending on the way it comes about. The effect on financial institutions and on their customers will differ depending on whether interstate banking comes through liberalization of McFadden (branching), elimination of the Douglas Amendment (bank holding company acquisition), or through greater exploitation of other devices.

While there is a presumption that interstate banking eventually will be allowed nationwide, a number of proposals have advocated *limited* interstate banking, either permanently or as a means of phasing in the eventual nationwide system. These proposals include regional interstate banking, limits on the number of interstate acquisitions, or limitations on the method of entry into interstate markets—*de novo* (starting a new bank) or through acquisition of existing institutions.<sup>1</sup>

### Different Avenues have Different Effects

In analyzing the impact of different methods of interstate banking, it is useful to consider the effect on four types of bank customers—large corporations, middle-market firms, small businesses, and consumers.

The easiest to deal with are the large national firms. Competition for their business is already national in scope. The largest banks in the country are seeking the business of Fortune 500 or 1,000 firms, regardless of location of either the bank or the corporation. This competition does not require a local branch or subsidiary bank. Thus, money center banks can compete for Lockheed's business without maintaining a branch in Atlanta. If physical presence is desirable, a loan production office, legal under existing law, is usually adequate.

Small businesses are now served exclusively by local lenders. The small firm in Orlando obtains banking services from Orlando banks. The small businessman from Orlando who seeks credit at a Miami bank will be greeted with courtesy, no doubt, but also with suspicion as to why he is unable to meet his needs in his own

<sup>1</sup>Various approaches to interstate banking are also discussed by Alan S. McCall and Donald T. Savage in "Branching Policy: The Options," *Journal of Bank Research*, Summer 1980, pp. 122-126.



locality. For that small Orlando firm, seeking financing in Atlanta is out of the question.

The devices that currently allow interstate activity, such as loan production offices or Edge Act corporations, are not an efficient means of serving the small business borrower. Loan production offices are staffed with lending officers experienced in seeking business from large corporations. The offices are not set up to make smaller loans and, in any case, they are not allowed to take deposits. Part of the consideration involved in a bank lending transaction is the opportunity to obtain a borrower's deposit account. If the nonlocal bank cannot compete for the deposit account, it is at a disadvantage in competing with local institutions. Some subsidiaries of out-of-state bank holding companies, such as finance companies or leasing subsidiaries, can extend credit to a small business; but they too lack the opportunity to handle its deposit account. The effect on the local small business of a change to allow interstate banking will depend heavily on the specific form of the change.

*De novo* entry (establishment of a new bank) by an out-of-state bank generally will benefit small business customers more than entry through acquisition. *De novo* entry adds to the small firm's sources of service while entry by acquisition merely substitutes one bank for another. This substitution is not without effect, however, and the effect of a *de novo* establishment of an out-of-state bank's branch differs from a *de novo* bank holding company subsidiary.

An important distinction between a branch and a bank subsidiary of a bank holding company is that the branch's lending limit is based on the capital of the entire bank, while the subsidiary is limited by its own capital. Thus, the branch of a money center bank established in Atlanta or Birmingham can make a multi-million dollar loan to large local firms. An important implication is that an out-of-state branch can emphasize service to larger businesses in an area, while the bank subsidiary of a bank holding company must be oriented toward small business customers and consumers.

It follows, therefore, that small businesses may be benefitted more by establishment of a bank holding company's subsidiary than by its branches. Analogously, the competitive position of small local banks may be more affected by entry of subsidiary banks than by branches. This is an interesting consideration because it is frequently asserted—as in the Carter administration report

on the McFadden Act—that interstate bank holding company expansion is less disruptive to the existing competitive banking structure than interstate branching.

Acquisitions have a somewhat different impact. When a sizable local institution is taken over by an out-of-state institution (whether to be operated as subsidiary or as a branch), it may become less locally oriented in its lending policy. If so, change would not benefit local small businesses but, conversely, it would represent less of a competitive threat to local small banks.

The effect of interstate activity on smaller banks also varies depending on location. Small banks in major cities already face stiff competition from large banks. Small banks in Atlanta, Tampa or Miami compete with the largest institutions in their state. Evidence suggests that small firms prefer to deal with smaller banks, and small banks have long operated profitably in this competitive environment. Thus, *de novo* interstate branching or bank holding company expansion is unlikely to represent a significant change in the competitive structure of those cities. And if a large local competitor is acquired by an out-of-state institution, the small local bank's competitive position is probably improved.

The bank in a smaller city or town may be affected significantly by entry of a large out-of-state bank, but such banks are unlikely to enter *de novo* into smaller cities. There are limits to the pace at which even the most aggressive bank can expand following a change in the law—limits that we will discuss later. The small-city bank is most likely to find itself in direct competition with an out-of-state institution if that institution acquires an existing competing bank or its parent. Thus, an independent bank in Macon may find itself competing with a subsidiary of a money center bank holding company if a New York or Chicago bank acquires a local competitor or the parent of a local competitor. But the local bank's ability to compete with the money center bank for small business customers is at least as good as its ability to handle existing competition.

The banks most likely to be affected by interstate competition appear to be larger institutions doing business with locally based middle-market firms. Those firms, the best customers of the larger in-state banks, will be the principal targets of out-of-state entrants into the market. In many states, these firms already have access to many of the larger banks in the state, and they may not have much to gain from new competition. On



the other hand, in some smaller states or those with a concentrated banking structure, these middle-market firms may see a significant improvement in their access to bank services.

Potential interstate entrants much prefer branch expansion over holding company acquisitions because it allows them to tailor expansion to the particular market being entered. It is feasible to establish a wholesale oriented branch at lower cost—requiring less capital, modest office space and few employees. Such an operation may be little more than a deposit-taking loan production office. If interstate banking comes about through change in the Douglas Amendment, allowing only *de novo* bank holding company subsidiaries, the cost and difficulty of raising sufficient capital will hold down the number of interstate ventures.

### Effects on Consumers

When interstate expansion's objective is consumer business, analyzing the alternative types of interstate expansion becomes more complex. First of all, a major objective of interstate consumer banking has been attracting low-cost core deposits. Consumers traditionally have maintained sizable demand deposits (on which no interest is

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*“Regardless of any change in federal law, consumer banking appears likely to become less locally limited.”*

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paid), NOW accounts and saving deposits (with interest at 5¼ percent), and other fixed-maturity time deposits with below-market interest rates. The phase-out of interest rate ceilings and the recent creation of money market accounts and super-NOW accounts at competitive market rates, may make consumer business less profitable to commercial banks in the future. Thus, some of the motive for interstate expansion in this market may have lessened or disappeared.

Second, it is unclear whether **any** change in the law is necessary to conduct consumer business on an interstate basis. On the lending side, finance company subsidiaries of bank holding companies have the necessary powers and already can operate interstate. Savings and loan associations have gained full consumer banking powers, both in lending and deposit-taking (including checking

accounts). If bank holding companies were allowed to own S&Ls on an interstate basis, change in the McFadden Act or the Douglas Amendment would not be needed to bring about full interstate competition in consumer banking. Loan limits are not a problem in consumer lending, so a branch is not a more attractive vehicle for interstate entry than a holding company subsidiary.

The Federal Reserve already has authorized bank holding company acquisition of an S&L in a few exceptional cases, the most dramatic being Citicorp's acquisition of Fidelity Savings and Loan in California.<sup>2</sup> A Federal Reserve staff study recommended that the savings and loan business be considered an appropriate activity under Section 4(c)(8) of the Bank Holding Company Act, but the Board has sought congressional guidance before making a general decision in this controversial area.<sup>3</sup> The 1982 Garn-St Germain Act authorized interstate and inter-industry acquisitions of failing thrift institutions. The legislation clearly treats such acquisitions as exceptional, which can be interpreted as a congressional intent that such acquisitions should not be allowed under “normal” (non-failure) circumstances.

Even without the S&L vehicle, existing mechanisms may be sufficient for carrying out consumer banking business interstate. Banks can and do solicit credit card business nationwide. Banks can also solicit deposits by mail on an interstate basis, and a number of large banks have begun to do so in connection with the new money market accounts. Money market mutual funds familiarized consumers with the idea of handling liquid asset portfolio transactions by mail with distant institutions, and the large commercial banks now are taking advantage of that familiarity. Customers of out-of-state banks can be given local access to their funds through automated teller machines. Shared interstate ATM networks are being expanded. Consumers will still probably prefer to keep their checking account local, however.

Regardless of any change (or lack of change) in federal law, then, consumer banking appears likely to become less locally limited. If local market conditions are not competitive, or if local banks are inefficient or unable to provide modern

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<sup>2</sup>See “Citicorp's Acquisition of Fidelity Federal Saving and Loan Association of San Francisco,” **Federal Reserve Bulletin**, October 1982, pp. 656-660, and Interstate Financial Corporation's Acquisition of Scioto Saving Association, Columbus, Ohio,” **Federal Reserve Bulletin**, May 1982, pp. 316-318.

<sup>3</sup>“Bank holding company acquisitions of thrift institutions”—staff study prepared for the Federal Reserve Board September 1981.



services, out-of-state banks will be able to solicit business successfully. Local offices may be less necessary in the future than they have been in the past. Interest rate ceilings have prevented banks from competing on rates, so convenience has represented the most important dimension of competition. But that is no longer the case.

It is difficult to predict just how consumer financial services will be delivered in the future. Rather than seeking a local presence, large, consumer-oriented banks may franchise or sell sophisticated services to local banks. The non-local vendor may be able to extract much of the potential profit from consumer business through service fees paid by the local bank. In any case, competition for consumer business is becoming more intense. The consumer, except in relatively isolated communities, may not need further change in the law.

### Implications for Intrastate Branching

These consumer banking considerations have implications for the desirability of intrastate as well as interstate branching. One of the most controversial aspects of interstate banking has been its effect on state control over banking structure, particularly the extent of branching within a state. We have noted that the McFadden Act defers to state law with respect to geographical limits on branching by national banks. But this may be less important in the future, as extensive branching becomes less profitable.

Consumer banking traditionally has involved collecting funds from depositors at low interest cost on the basis of convenience. Where state law has allowed, convenience has been provided through extensive (and expensive) branch facilities. If banks have to pay market rates for these funds, they no longer will be able to afford the cost of such facilities—estimated at perhaps 2 percent of funds collected. Direct deposit, automated clearing houses, and automated teller machine networks may provide consumer convenience in the future, and the longstanding debate over branch banking may fade away.

If branching continues to be a matter of controversy, however, changing the Douglas Amendment would do much less violence to traditional state control over intrastate branching than would liberalization of the McFadden Act. This consideration apparently was given heavy weight in the Carter administration McFadden Act Report,

which recommended the Douglas rather than the McFadden route to interstate banking.

### Restraints on Interstate Expansion

There seems to be a widespread belief that removal of the McFadden Act or Douglas Amendment immediately would spark a tremendous expansion of interstate branching or holding company activity. This rests on the assumption that the sole barrier to interstate activity is the legal one, and hence if that barrier were removed interstate activity could proceed unencumbered. However, other factors will tend to limit interstate holding company activity even after legal barriers are removed.

Three types of constraint that will persist include considerations relating to the profitability of the target area, constraints based on the capacity of the expanding bank, and legal/regulatory constraints. A bank holding company does not expand interstate in the abstract; it must have a particular market in mind. However, there are only a limited number of attractive banking markets—markets in which the expanding bank can expect to operate profitably. Atlanta, for example, may appear to be an attractive location for a money center holding company to organize a new bank or acquire an existing bank. But it is less attractive considering the possibility that five or ten or more other holding companies may try to do the same thing. This problem exists with either a *de novo* banks or an acquisition. A rash of *de novo* banks would increase competition and reduce profitability. The acquisition route would not directly add to the number of competing institutions in the market. But if a number of potential acquirers pursue a limited number of attractive acquirees, the price of their stocks will be bid up. Earning a profit on an acquisition requiring a substantial premium would prove difficult.

Even if there are attractive opportunities available to aggressive bank holding companies, the holding companies remain subject to their own internal limitations. The most important are likely to be capital and management shortages. Few money center banks have more capital than supervisory agencies view as marginally adequate. Expansion through *de novo* holding company subsidiaries requires additional capital. While acquisition of an existing bank through an exchange of stock does not necessarily require new capital, its feasibility turns on the capital market's



valuation of the stock involved. The key issue in all cases is the holding company's ability to tap the capital markets. While capital considerations do not necessarily constrain interstate expansion, the current state of both equity and debt markets will make it difficult for most large banks to generate the additional capital needed to finance a substantial expansion.<sup>4</sup> Capital will be a more serious constraint on holding company expansion than on branching.

For many banks considering nonlocal expansion, the pace of such expansion will be limited by management talent. This has, in fact, already limited the pace of expansion by some banks, which see the opportunity for profitably establishing additional loan production offices but lack the qualified lending officers to staff them.

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*"Even if there are attractive opportunities available, holding companies remain subject to their own internal limitations."*

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That problem becomes more severe when an entire bank must be staffed. Of course, the problem is less if an existing bank with competent management is acquired. Yet, unless the acquiring bank is able to devote some managerial expertise to the acquisition, it is likely to represent merely a financial investment, not a true merging of the acquired institution providing real operating economies or advantages.

Even with change in the Douglas Amendment or McFadden Act, other delays and constraints are inherent in the regulated nature of the banking business. Organization of a *de novo* subsidiary bank or branch or an acquisition requires at least one regulatory approval, and usually more. The pace of much regulatory agency decision making can be slow, particularly when applications involve controversial issues. That certainly will be the case with applications for interstate charters or acquisitions. There are

really two separate problems involved: first is simply the supervisory agencies' ability to handle the flow of paper if 100 or 200 applications for interstate operations are added to a volume that already strains the agencies' resources; second is the difficulty the agencies will face in making necessary policy decisions on the applications.<sup>5</sup>

Since sizable acquisitions are likely, we must also consider the role of the Justice Department and the courts under antitrust laws. Some applications of antitrust concepts to banking have been rather clearly resolved. A series of bank merger cases decided by the Supreme Court in the 1960s (in particular, Philadelphia, Lexington, and Phillipsburg), combined with the 1966 amendments to the Bank Merger Act, set clear limits on horizontal bank mergers—mergers involving banks in direct competition in the same market. These standards have been applied consistently by the banking agencies, and have been understood by banks and their counsel, so mergers that would be prohibited by these guidelines are rarely even proposed.

The courts have spoken less clearly in the case of "market extension" mergers—those involving the issue of "potential competition." In these cases, the two parties to the merger are not in direct competition in the same market. The acquiring bank is alleged to have the capacity and the interest in entering the market of the acquired bank on a *de novo* basis, or through a merger with a smaller bank now in the market (a "toehold" acquisition), thus encouraging competition. It is also often argued that the acquiring bank is already affecting the market because banks in the area, aware of the competitor "waiting in the wings," refrain from pricing strategies that would encourage entry. The Justice Department has brought suit in several cases on the grounds of "potential competition" and "probable future competition," but has lost every time. Debate over the applicability of potential competition has been intense, both in banking and

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<sup>5</sup>Several methods of reducing this problem warrant attention by the Congress. Congress can put a deferred effective date on legislation authorizing interstate banking. During this period, perhaps a year or longer, the agencies can determine policy and establish procedures to be used when the applications are received. Congress could provide some guidance as to policies to be followed by the agencies. Congress could also impose a firm deadline for decision making, as it has done with bank holding company acquisitions handled by the Federal Reserve. The agencies could accept applications during the interim period, and decide them all as of the effective date of the legislative change. A similar approach was used when Florida first authorized branching, avoiding the inequity that results when Bank A has its application approved and gains a head start on Bank B, whose equally meritorious application happens to fall later in the queue of cases.



other contexts. Courts generally have acknowledged applicability of the argument in principle, but have never found the facts sufficient to rule for the Justice Department. The result is a great deal of uncertainty as to what is allowable and what is not.

Bank acquisition cases involving potential competition have been a relatively minor factor in changing bank structure. But this issue will come to the fore if barriers to interstate banking are eliminated. Virtually all acquisitions in such a framework would be market extension acquisitions that would raise potential competition issues. Most of the banks that would seek interstate acquisitions are large and probably would prefer to acquire banks that have a significant market share. There is nowhere a bank can turn to obtain accurate guidance as to which possible acquisitions will meet the test of the antitrust laws and which will be barred.<sup>6</sup>

Uncertainty does inhibit mergers. Many mergers make economic sense if they can be handled smoothly, but are not worthwhile if they require huge legal costs to complete. Thus, inhibited mergers are not simply those that agencies or the courts would rule unacceptable, but also many that would, if carried to a final Supreme Court decision, be found to be legal. While some advocates of a strong anti-merger policy view this inhibiting effect as desirable, uncertainty of the law scarcely promotes economic efficiency.

These considerations suggest that even if there is a change in the law to allow unlimited interstate banking, the pace of such expansion will remain subject to important constraints.

## The Role of Foreign Banks

While these considerations will limit the pace of interstate expansion by U. S. banks, foreign banks should be considered separately. Before the International Banking Act of 1978 (IBA), foreign banks were allowed to operate full-service banking offices in more than one state. Several operated in both New York and California. Such activity was frozen by the IBA, but many foreign banks retain an interest in interstate expansion if the law should allow it. A number have already taken advantage of liberalized restrictions on Edge Act Corporations to establish

such operations in several cities, with Miami and Houston the preferred locations.

Some foreign banks are interested in consumer business, a traditional strength of the British banks. Several Japanese banks have been successful in consumer banking in California. Yet most foreign banks are interested in middle-market firms that may have links to their home country or that may have use for a foreign bank's particular expertise. For example, many middle-sized Texas firms are suppliers to oil operations in the North Sea, the Middle East or Latin America, and banks from these areas may seek an office in Houston or Dallas. With the exception of foreign banks interested in consumer banking, the type of business contemplated can be more efficiently handled with a branch rather than a holding company subsidiary.

This aspect of interstate banking is significant because there are probably more foreign banks interested in interstate expansion in the United States than there are domestic banks capable of such activities. Of the 500 largest banks in the world, 403 are non-U. S. banks, and 142 of these are already operating in the United States.<sup>7</sup> While the IBA attempted to put foreign and domestic banks on an equal competitive basis (removing the foreign banks' freedom from reserve requirements, for example), foreign banks may still enjoy some advantages in interstate expansion. Most important is in the regulation of capital. Many foreign banks are allowed to operate with lower capital ratios than U. S. banks (substantially less than the **regional** U. S. banks they will compete against). If a foreign bank establishes a branch in the United States, it may be feasible for U. S. authorities to police the capital adequacy of that office, but more difficult to regulate the capital of the entire organization. It is easier to regulate the capital of a bank holding company subsidiary (it is a domestic bank), but it is not clear whether the Federal Reserve can or should attempt to regulate the capital adequacy of a consolidated foreign bank holding company as it does with domestic bank holding companies.

If interstate banking is authorized, the share controlled by foreign banks will increase substantially, particularly if branching rather than holding company expansion is authorized. While several studies have failed to find any detrimental

<sup>6</sup>For a further discussion of antitrust issues in interstate banking, see Steve A. Halbrook and Donald T. Savage, "Interstate Commercial Banking: The Antitrust Issues," *Banking Law Journal*, September 1981, pp. 747-767.

<sup>7</sup>*American Banker*, July 28, 1982, p. 41.



effects associated with an increased foreign bank role in the U. S. banking system, this is likely to become at least a political issue.

## Proposals for Limited Interstate Banking

Despite evidence that much interstate banking already exists, many consider too drastic any change in U.S. law to allow full service nationwide banking. Some argue that limited interstate banking can provide the advantages cited for nationwide banking with fewer disruptive effects, while others argue for a limited approach temporarily to cushion the impact of a change to nationwide banking.

The most restrictive approach would be to allow branching (or holding company acquisitions) only within standard metropolitan statistical areas, or SMSAs. The Hunt Commission urged that states be progressive in changing their laws in recognition of the fact that several banking markets are divided by state lines.<sup>8</sup> The New York City SMSA includes portions of New Jersey and Connecticut, while the Washington SMSA includes several counties of Virginia and Maryland. Other SMSAs include portions of a second state. Because current banking economics make extensive branching within an SMSA less attractive, this proposal has less to recommend it now than in the past. ATMs can accomplish nearly all the benefits previously attributed to intra-SMSA branching.

There are many proponents of regional interstate banking, particularly among the large regional banks. At one level it is easy to dismiss such suggestions as self-serving. The regional banks naturally want the opportunity to move into attractive banking markets in nearby states, while keeping the money center banks out of their territory. But basic economic similarities among groups of states could provide economic efficiencies from limited interstate banking. The bank serving textile manufacturers in Georgia, for instance, can bring experience and expertise to similar customers in the Carolinas that a Minneapolis bank cannot. Lending to wheat growers in Kansas is similar to lending to wheat growers in South Dakota; oil drilling in Wyoming is similar to drilling in Colorado.

In particular, smaller firms may benefit from increased competition that can result from regional interstate banking. The small furniture manufacturer in Virginia may not be a customer sought by a money center bank moving into that state, but may be desirable to the North Carolina bank already familiar with the business. On the other hand, banks from nearby states may already be a competitive force in the market.

The basic problem with proposals for regional banking is that no one has been able to define regions on a logical and consistent basis. In an attempt to overcome the essentially arbitrary nature of regional classification, many have seized on the concept of contiguity. Neighboring states are usually similar in economies. But this basis is

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*"Some argue that limited interstate banking can provide the advantages of nationwide banking with fewer disruptive effects."*

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also arbitrary and clearly inequitable in its treatment of banks in different states. Contiguous state branching would give Florida banks access only to Georgia and Alabama, while Nevada banks would have access to California, Oregon, Utah, Idaho and Arizona. In fact, such a limitation would encourage the artificial shifting of headquarters. A Florida bank could enter Georgia and make Georgia its headquarters, thus enabling it to enter states not open to it from Florida. This artificial movement has taken place in Pennsylvania under that state's contiguous county branching law. Again, this approach bases treatment of banks on their location rather than their efficiency or ability to operate on an interstate basis. While such a limited approach to interstate banking might be justified as a step toward eventual nationwide banking, it is not a reasonable permanent solution.

A final approach involves limiting the number or the method of interstate operations, rather than the location. Our current banking structure grew out of a traditional American fear of concentrated financial power. No other country has so many commercial banks. Those who see this as an attribute of the U.S. financial structure fear that nationwide banking could lead to a wave of

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<sup>8</sup>See The Report of the President's Commission on Financial Structure and Regulation, December 1971, p. 62.



mergers creating a concentrated banking system such as that of England or Canada.

One means of preventing this, while gaining the benefit of broader interstate banking, would be to allow interstate expansion on a *de novo* basis only. Entry under such a rule necessarily would increase competition rather than concentration. The ultimate effect of such an approach is not clear, however. Many banking markets are already competitive. Additional new entry could require the exit of existing firms. If banks were precluded from selling out to out-of-state institutions, we would see an increase in intrastate mergers. The ultimate net effect on concentration might be the opposite of what is intended. Further, interstate mergers offer an efficient means of resolving problems of failing institutions. Barring such mergers would sacrifice a major potential advantage of interstate banking.

For directly opposite reasons, some favor interstate banking through merger only. Proponents of this approach argue that the U. S. banking system is too fragmented, with many banks too small to achieve economies of scale. Interstate acquisitions could reduce the number of banks without necessitating mergers between directly competing institutions. (Some believe the approach taken in the Garn-St Germain Act is ideal in that it allows such mergers only when necessary to prevent a failure.)

This proposal has a political advantage. Many bankers oppose interstate banking because they fear increased competition from giant out-of-state institutions. Interstate banking limited to mergers may remove their fear of a money center bank opening an office next door and may offer investors a greater number of potential buyers when it comes time to sell their bank.

Fear of the disruptive impact of liberalized interstate banking on the competitive structure

clearly is the principal reason such activity has been restricted. Proposals for limited interstate banking attempt to deal with this problem. An alternative means of cushioning the immediate impact of a change is to limit the number of interstate ventures that each bank can undertake. Banks could be restricted to a few acquisitions or *de novo* entries per year. Over time banks would be allowed to operate nationwide, but restrictions in the early years would enable the regional banks to strengthen their operations while facing only limited direct competition from money center banks.

Economic and regulatory constraints are probably sufficient to obviate such legal restrictions. It is unlikely that even the largest banks in the country could plan, negotiate, and finance several major interstate ventures in the first year such activity is legalized. Nevertheless, a legal constraint may provide comfort for some who otherwise might oppose interstate banking.

## Conclusion

Because interstate banking has long been a matter of intense controversy, it is important that advantages and disadvantages be discussed thoroughly. But much of that discussion necessarily takes place in the abstract in terms of interstate banking generally rather than focusing on the effects of specific approaches to interstate banking. Our purpose has been to suggest that those effects differ depending on the route chosen toward interstate banking. Any discussion of the merits of changing the McFadden Act or the Douglas Amendment must recognize that many means of engaging in interstate banking already exist, and that such activity will increase even without change in fundamental restrictions on interstate activity.

—Paul M. Horvitz



# Interstate Expansion and Bank Costs



The evolution of interstate banking will be influenced importantly by the relationships between banks' unit costs and their size—measured in assets, number of offices and geographic extent. Expansion of banks beyond their headquarters states implies increases in all three dimensions. The potential expansion will be limited to the extent that unit costs (operating costs per loan booked and deposit account serviced) rise as banking organizations grow through interstate expansion. If unit costs rise sharply, expansion would cut into profits and would be strictly limited. If unit costs remain constant or nearly so, more expansion would take place, and if unit costs decline with size, rapid expansion would be likely.

As previous articles in this **Review** have indicated, there are several methods of interstate expansion; these may affect bank costs differently. Whitehead's work (17) indicates that extensive interstate banking already occurs through a variety of methods. Because methods vary greatly from bank to bank and because rapid interstate expansion is relatively recent, there has been little systematic accumulation of data on or analysis of overall costs of these interstate operations or of the impact of expansion on costs.

We are better prepared to look at the potential impact of interstate branching if the McFadden Act is repealed and the impact of interstate bank holding company operation of banks if the Douglas Amendment is repealed. Costs of branching and bank holding company operations on an intrastate basis have been studied extensively. This article summarizes the results of these studies, discusses their limitations and draws implications from them.

Since banking structure appears to influence banks' pricing of their services, we would like to know how much consolidation of the system to expect. Since the

*Evidence suggests that bank costs increase as size increases. While interstate banking may bring more services to local markets, cost advantages of large banks do not seem great enough to trigger rapid consolidation within the industry.*



financial system's health is related closely to bank profits, we would like to know how expansion and consolidation would affect costs and, hence, profits. Since the public's outlays for financial services are influenced by the cost of such services, we would like to know how interstate banking would impact costs.

In order to judge how bank costs react to interstate expansion, we would like to see studies of bank costs based on interstate experience. These do not exist, at least not in published form, but there are cost studies that deal with banks of all types, including those with extensive intrastate office networks. These studies and other observations provide extensive, though incomplete, evidence on which to base some tentative conclusions about the reaction of costs to interstate expansion. (Two recent and more detailed discussions of these studies are found in papers by Benston, Hanweck and Humphrey (4 and 5) and McCall (13).)

### Branching and Unit Costs

As banks expand through branching, unit costs may rise, remain stable or fall. Will interstate banking expand quickly or slowly, or not at all? Will it result in extensive consolidation and will such branching significantly impact bank customers' costs? It all depends importantly on the reaction of costs to the size of branch banks and the costs of their unit bank competitors.

Studies of this relationship have appeared with some frequency over the past 30 years.<sup>1</sup> These studies generally have relied on formal production functions and individual bank cost data generated in the Federal Reserve Banks' functional cost analysis (FCA) program. They have built upon one another using increasingly elaborate methods of measurement and statistical analysis to estimate banks' unit operating costs in relation to the volume of specific financial services that they produce. A few have attempted to consider the impact of overall bank size on unit costs by adding together cost functions for individual products.<sup>2</sup> The two most recent studies in this line provide several advances over previous studies and analyses of recent banking cost data.<sup>3</sup> They will receive most of our attention.

<sup>1</sup>See Benston, Hanweck and Humphrey (4, pp. 17-20) for a detailed summary of these studies.

<sup>2</sup>These include studies by Bell and Murphy (2), Murphy (15) and Benston, Hanweck and Humphrey (4 and 5).

<sup>3</sup>These are the studies by Benston, Hanweck and Humphrey (4 and 5) and Gilligan, Smirlock and Marshall (7).

The study by Benston, Hanweck and Humphrey recently published in this **Review** (4) advances on previous studies in its measurement of bank output, the form of its cost function and its treatment of expansion by adding branches. Its method of measuring overall output allows the identification of upwards of 70 percent of bank costs with a single index of bank output. Its cost function allows, but does not require, U-shaped cost functions—functions that allow for declining unit costs at low levels of output and rising unit costs at higher levels of output. Its method of including branches corrects previous methods, which probably overestimated costs of adding branches at larger banks.

This study dealt with banks having deposits up to \$1 billion. Its authors found that unit banks experienced some diseconomies of scale as their size increased beyond \$75 million in deposits, that is, their average cost increased as their size increased. Branch banks experienced economies of scale when they expanded output without increasing their branches. However, when branch banks increased their output by adding branches (as they generally do and would be forced to do if they moved into interstate banking), they also experienced diseconomies of scale beyond the \$50 million—\$75 million deposit size.

The study's major conclusions with relevance to interstate branching were that a) costs increase slightly with bank size for branch and unit banks with \$50 million—\$75 million in deposits or more when branch banks expand by adding new branches and b) when normal methods of expansion are accounted for, branch and unit banks of similar deposit size have similar costs. These conclusions differ from those of earlier studies in that they find slight diseconomies of large-scale banking while the others generally find slight economies of large scale.<sup>5</sup>

The study by Gilligan, Smirlock and Marshall (7) is a pilot-type study combining measures of economies of scale and economies of scope in producing bank products. It uses a similar production function to that used by Benston and his colleagues (4) and analyzes FCA data. Its principal advance is its consideration of economies of scope.

<sup>4</sup>McNulty (14) found similar results for savings and loan associations in a study that used similar methods. This study also reviews cost studies of savings and loan associations—most of which have results that are generally consistent with the studies of banks.

<sup>5</sup>Murphy (15) studied banks as large as \$5.5 billion in deposits.



Economies of scope occur when the combined cost of producing two or more products in the same operation is lower than the combined cost of producing the same products separately. Banks are multi-product firms and they produce combinations of services with the same people and equipment. Tellers handle various types of deposits, computers keep records on all transactions and the same physical plant may house several functions. Thus, tests for economies of scope seem justified. If economies of scope are significant, banks might be able to decrease the unit cost of each type of output by adding new types of output as they grow.

The study by Gilligan, Smirlock and Marshall finds no evidence of economies of large scale in commercial banks. However, in its limited test, it found evidence of economies of scope in overall bank production when either of its two methods of measuring overall output was used. These results raise, rather than answer, the question of whether economies of scope show up when more detailed output measures are used and whether large banks offering multiple services might gain sufficient cost advantages to undercut small banks' prices on basic services.

These two studies show no evidence of scale economies for banks above a relatively small overall size. In this they differ from most previous studies which show slight scale economies. The two most recent studies, however, are among the few to use functional forms that allow U-shaped cost curves, thus allowing rising unit costs as size increases. They also analyze the most recent data (from the late 1970s), which might account for their findings.

Cost studies of individual bank functions have a history similar to estimates of overall costs. Most of these studies made no allowance for diseconomies of large scale through U-shaped cost curves. They found slight economies for most individual functions. Studies using more recent data showed less cost decline. The study by Benston and Hanweck (3) allowed for U-shaped cost curves and found them for the demand deposit function; other functions showed constant costs, except business loans, which showed continuing economies of large scale production. These results might have resulted either from changes in the way banks operate or from a method that allowed U-shaped cost curves. That the latter is more likely to be the reason is shown by a recent study by Dunham (6), in which economies of scale were shown for

all five of the functions measured, with a function that would not allow U-shaped curves.

Thus, economies of scale studies seem to indicate that large banks have no unit cost advantage over smaller ones—at least not over banks as large as \$50 million in deposits. Unit and branch banks have similar cost functions throughout the output range if branch banks increase output by adding branches. Advantages or disadvantages of any group of banks are slight. In a later section of this article, we will discuss some reasons why these results are not conclusive.

## Bank Holding Company Expansion

Interstate banking by bank holding companies involves an extension of the above evidence on economies of scale in branching. Since a bank holding company is a collection of banks, evidence already discussed on individual banks should tell us about the units that make up the holding company. That evidence indicates that branch

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*“Economies of scale studies...indicate that large banks have no unit cost advantage over smaller ones.”*

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and unit banks achieve economies of scale only up to a fairly small size and have slight diseconomies beyond \$50 million—\$75 million. But does ownership by a bank holding company impart anything to a collection of individual banks that would change their cost structures? If holding company ownership raises costs above those that an individual branching system might achieve, we would expect less consolidation and higher banking costs after removal of the Douglas Amendment than after removal of McFadden Act branching prohibitions. If it reduces costs, we would expect more consolidation and lower costs.

Bank holding companies can centralize some operations of their subsidiaries—investment, trust, audit, data processing and accounting for example. This may allow them to operate each subsidiary more efficiently and to achieve greater economies of scale than independent banks, but not necessarily more efficiently than branch organizations



of similar size. On the other hand, greater information and coordination costs inherent in larger, more formally structured organizations may cancel such efficiencies.

Several studies have tested the impact of bank holding company ownership on individual banks' costs to determine the effect of these forces on the unit costs of affiliated banks. Five studies have been published over more than a decade on the impact of holding company affiliation on efficiency. Their results occasionally conflict and are not, on the whole, conclusive because each study has important problems.

The two earliest studies (Schweitzer, (16) and Kalish and Gilbert, (8)) treat bank assets as their measure of bank size. Beyond that similarity, the studies differ in most important respects, including their conclusions. Schweitzer analyzed annual income and call report data for banks in the Minneapolis Federal Reserve District in 1964. Kalish and Gilbert analyzed national FCA data for 1968, computing cost relationships using only the most efficient banks.

For reasons not ascertainable because of important differences in methods, the two studies reached opposite conclusions about the impact of holding company affiliation on efficiency. Schweitzer found that small (assets less than \$25 million) affiliate banks were less efficient than small independents, while large affiliates were more efficient. Kalish and Gilbert, dividing small from large banks at \$10 million of loans and investments, came to the opposite conclusion.

Schweitzer's conclusions generally were echoed in a study of demand deposit costs of 1968 FCA banks by Longbrake and Haslem (12). Their study measured three components of demand deposit output: average account size, average number of accounts per office and number of offices. Their results indicated that affiliates with less than average account size and less than average accounts per office (generally smaller banks) had higher average costs than similar independents, whether branch or unit banks, while affiliates with greater than average account size and accounts per office had lower average costs. This study did not estimate cost functions for other bank functions or for the bank as a whole; consequently, it is not directly useful for drawing implications of expanded bank holding company activity for overall bank costs.

Benston and Hanweck (3) studied costs of several important banking functions using 1968-1974 FCA banks in an analysis of the overall

effects of affiliation on bank costs. For only one of these functions did affiliates' efficiency differ from that of independents. In the demand deposit function, affiliates had lower average costs than independents, and affiliates' advantages grew with holding company size (rising from 4 percent for a small company to 17 percent for a large company). In the other functions studied—time deposits, business and agricultural loans, real estate loans, installment loans, administration, occupancy, business development and promotion—holding company affiliation did not influence bank costs.

These results are consistent with those of Longbrake and Haslem to the extent that they indicate large holding companies have higher than average account size and accounts per office. The results indicate little other affiliate advantage. The study did not cover all bank functions, however, and the cost functions were not aggregated. Thus, overall effects were not strictly discernible from the Benston-Hanweck study.

To a great extent this criticism was obviated by a more recent bank cost study by Benston, Hanweck and Humphrey. This work, the most recent available, aggregates at least a large proportion of bank costs. It is probably our best guide in assessing the impact of affiliation on bank costs. Using a newly developed index of combined output of most functions that generate bank costs, these researchers studied 1974-1978 FCA banks. Accounting for both the fact of affiliation and the size of the bank holding company, they found no significant effects of affiliation on the bank costs they reviewed. Holding company size was not found to be an influence.

## Limitations of the Evidence

The cost studies reviewed here leave unanswered some questions that are important in the appraisal of interstate banking costs. Three of the most glaring questions involve very large banks. The studies we have reviewed do not cover the largest banks—those with deposits greater than \$1 billion—yet these are the ones most likely to act in the event the McFadden Act or Douglas Amendment is repealed. The studies also generally fail to deal with economies of scope—adding additional products to the output of an expanding firm. The one study that does test for economies of scope finds them, but its tests are not general.



In addition, they do not cover the influence on costs of widespread bank holding company and branching systems, since the banks studied operated statewide systems at the most.

Large banks and economies of scope are closely related. Gilligan and his colleagues (7) question recent evidence that most bank products suffer diseconomies of scale and that banks overall appear to suffer diseconomies when these individual cost functions are added up. They find such evidence inconsistent with the existence of large banks. Economies of scope that involve the interaction of bank product costs may explain the inconsistency. If additional products reduce costs of existing products, banks may be able to add new products as they grow and to reduce the costs of other products, thus overcoming diseconomies of large scale. Very large banks may thrive in such situations, though smaller institutions show no economies of scale in traditional products.

Direct evidence on these questions is limited to the two-product test of economies of scope in the Gilligan paper. However, indirect evidence that even very large banking organizations have had limited success when they enter new markets indicates that large banks' advantages are not extensive. This evidence is summarized in King (9 and 10); see also Keunreuter (11).

The cost impact of geographic extensions of bank branches or bank holding companies' subsidiaries beyond their headquarters states is not known. Certainly communication is complicated somewhat by greater geographic spread. Some large statewide banks reportedly have had difficulty collecting data rapidly enough to meet regulatory reporting deadlines. Decisions on participations and large loans also cause some delays in present branching and holding company systems. Available evidence does not tell us whether a nationwide system would increase communications and administration costs significantly for the bank operating it. On the other hand, modern electronic communications media may help to avoid extra communications costs. Indeed the continuing operation of interstate nonbank office networks by several bank holding companies (see Whitehead, 17) leads to the presumption that such costs are not significant.

Also missing from bank cost studies is recent and consistent product-by-product evidence on bank costs. Recent evidence on individual product costs would help us to analyze the implications of interstate banking for specialized bank

activities. For example, continuously decreasing costs of demand deposits as reported by Longbrake and Haslem (12) or for business loans as reported by Benston and Hanweck (3), would imply that large institutions specializing in demand deposits and business loans might exist alongside smaller local institutions specializing in time

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*"Extensive consolidation of the commercial banking system seems unlikely."*

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deposits and consumer loans. This type of specialization could save money for the public, though it might increase concentration in certain product lines. Evidence on individual product costs is, however, inconsistent from study to study.

A final blind spot in evidence on bank size and costs involves risk. Larger banks may be able to diversify their assets to a greater extent than smaller ones and, consequently, to incur lower risk. (See Baltensberger (1)). Evidence of such advantages for larger banks in practice has not been developed. In their review of the bank size—bank cost relationship, Whitehead and Schweitzer (18) conclude that "...no systematic evidence exists that small banks are at a competitive disadvantage in terms of risk." The lack of evidence, they also point out, may be the result of the woefully incomplete study of this relationship.

## Summary and Conclusions

Evidence from commercial bank and savings and loan cost studies indicates that diseconomies of scale exist for institutions of all sorts—branch and unit, affiliate and nonaffiliate—above relatively low levels of overall size. Costs increase, in other words, as size increases. This evidence indicates that for specific products other than business loans and demand deposits, such diseconomies may also exist above rather low output levels. Bank holding companies do not appear to influence the efficiency of affiliates.

This evidence is incomplete and not entirely conclusive because it generally fails to cover very large banks or to consider economies of scope, costs of extensive geographic communication or



risk. With one exception, its evidence on costs of individual products may be outdated. There are reasons to believe, however, that these omissions do not greatly influence the broad overall conclusions based on the evidence.

The existence of some diseconomies after low output levels implies first that large institutions gain little in the way of lower costs to threaten small banks, to benefit the public or to convince investors that their expansion will reap a return greater than alternative investments. Under such conditions, extensive consolidation of the commercial banking system seems unlikely. The competitive impact of interstate branching or bank holding companies on banking structure would be limited. Regulators could analyze the competitive effect of mergers or acquisitions in local markets without fear that by denying bank combinations they could foreclose a lower output cost alternative. It would be sufficient to analyze criteria based on competitive effects.

The evidence also has implications for the benefits of interstate banking in terms of costs of banks' services to bank customers. The best available evidence indicates that widespread expansion by large organizations would produce no lower costs and possibly higher costs of banking services offered in their markets to the public since unit costs may actually increase with size. Interstate banking may, on the other hand, bring more services to local markets if large banks offering a wide variety of services expand nationwide.

In general, interstate banking appears to be neutral in its impact on the public through banks' production costs. Cost advantages of large banks do not seem great enough (if they exist at all) to trigger rapid consolidation and concentration within the industry, inhibiting competition. Nor, on the other hand, does expansion seem likely to provide the public with lower on-site costs of financial services.

—B. Frank King

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# Will Bank Capital Adequacy Restrictions Slow the Development of Interstate Banking?

Earlier in this **Economic Review**, Paul Horvitz points out that the McFadden Act and the Douglas Amendment aren't the only barriers to interstate banking. He cites three additional significant constraints to interstate expansion: the need for a bank to earn a profit in a new market, internal constraints to a bank's ability to grow (for example, its need for qualified personnel), and capital adequacy constraints imposed by bank regulators.

As this article suggests, the regulatory capital adequacy constraint may slow the growth of interstate banking organizations. While some academics have expressed doubts about the value of capital adequacy constraints the federal bank regulatory agencies consider bank capital adequacy before approving bank holding company acquisitions, bank mergers and *de novo* bank branches.<sup>1</sup> Regulatory approval can be denied if a proposed new consolidated entity lacks sufficient capital. Therefore whether or not capital adequacy constraints are justified, they may affect the expansion rate of interstate banking. If interstate banking is legalized, then



banks must have sufficient excess capital to support this growth, or they will have to raise additional capital if they wish to engage in interstate banking.

## Regulatory Capital Guidelines

Until December 1981, regulatory agencies attempted to regulate the capital position of bank holding companies on the basis of informal capital standards. At that time formal guidelines were announced for three groups: one set of guidelines for FDIC-regulated banks, another guideline for banks regulated by the Office of the Comptroller of the Currency and the Federal Reserve System and the guideline for bank holding companies. While all three agencies use the organization's capital (variously defined)-to-asset ratio as the primary measure of its capital adequacy, the agencies also will take other considerations into account when analyzing a capital position.

All three sets of capital guidelines group the regulated institutions into three zones:

- 1) those presumed to have acceptable capital,
- 2) those that may be undercapitalized
- 3) those strongly presumed to be undercapitalized.

The FDIC measures a bank's capital adequacy by its equity capital-to-asset ratio and imposes

<sup>1</sup> See for example, Sam Peltzman, "Capital Investment in Commercial Banking and Its Relationship to Portfolio Regulation," *Journal of Political Economy*, 78 (January-February 1970), pp. 1-26 or Lucille S. Mayne "Impact of Federal Bank Supervision on Bank Capital," *The Bulletin* (New York University Graduate School of Business Administration, Institute of Finance), 1972, Nos. 85-86 and for counterpoint see John J. Mingo, "Regulatory Influence on Bank Capital Investment," *Journal of Finance*, 30 (September 1976) pp. 1111-1121.

*Many community and smaller regional bank holding companies enjoy stronger capital positions than some larger regional and multinational companies. If regulatory guidelines on bank capital remain in place, they will affect the pace and extent of interstate expansion.*



the one guideline on all of the banks it regulates. It has established a threshold level of equity capital at 6 percent. Banks below this threshold will be required to submit an acceptable comprehensive capital plan. The FDIC also established a minimum acceptable level of equity capital at 5 percent. The FDIC will insist that banks below this level submit a plan to raise their capital promptly.

Guidelines of the Comptroller of the Currency and the Federal Reserve are more complicated. Those agencies use two measures of a bank's capital: primary capital, which consists of the bank's permanent equity capital, and total capital, which consists of its primary capital along with limited life preferred stock and subordinated debentures. Banks also are divided into three groups for the purposes of these capital guidelines: multinational banks (the 17 largest banks), regional banks (all other banks with more than \$1 billion in assets), and community banks (banks with less than \$1 billion in assets). The minimum primary capital-to-asset ratio is 6 percent for community banks and 5 percent for regional banks. Community and regional banks are "expected to operate above the minimum primary capital levels." Community banks whose total capital-to-asset ratio exceeds 7 percent are assigned to Zone 1, as are regional banks whose total capital ratio exceeds 6.5 percent. Community banks with total capital-to-assets between 6 percent and 7 percent and regional banks with ratios between 5.5 and 6.5 percent are assigned to Zone 2. Banks not assigned to Zones 1 or 2 are assigned to Zone 3.

Explicit capital standards have not been imposed on multinational banks. The lack of an explicit standard for multinationals does not mean, however, that the Comptroller and the Federal Reserve are unconcerned about the capital position of multinational organizations. Indeed one of the four objectives cited by the agencies for the new capital guidelines is "to address the long-term decline in capital ratios, particularly those of the multinational group."

The guidelines imposed on bank holding companies are similar to those imposed on banks by the OCC and the Federal Reserve. The guidelines are applied to the primary and total capital positions of the consolidated BHC with the BHC's primary and total capital defined in almost the exact same way as banks' primary and total capital are defined. The one significant difference is that BHC total capital includes bank

subordinated debt but excludes subordinated debt issued by the BHC parent and its nonbank subsidiaries.

These guidelines can be used by banking regulators to limit a banking organization's growth by rejecting banking organizations' merger and branching requests and by cease and desist orders. Under existing law the federal bank regulators can use their power to deny BHC and bank acquisitions' requests to prevent undercapitalized banking organizations from acquiring an existing or de novo bank. The law currently requires that the Federal Reserve approve all BHC merger applications and the federal agency regulating the surviving bank approve all bank mergers. The law requires that before such approval is given, the relevant agency must consider "the financial and managerial resources and the future prospects" of the banking organizations concerned. This gives the agencies the ability to reject the applications of banking organizations that are, in their opinion, undercapitalized.

Prior to the issuance of formal capital standards, all three agencies scrutinized the capital position of the proposed corporation when considering bank merger applications, and the Federal Reserve rejected some acquisition requests due to inadequate capital in the holding company or one of its affiliate banks. Since the new standards took effect, the Board of Governors of the Federal Reserve has rejected two applications by a holding company to acquire a bank due to the holding company's capital inadequacy. Last year the Board rejected a request that would have dropped a regional holding company's consolidated equity capital from 7.2 percent of assets to 5.8 percent of assets.<sup>2</sup> Furthermore, the Board noted that the company would have goodwill equal to approximately 25 percent of its equity capital.<sup>3</sup> The Board also rejected an application that would have reduced a bank holding company's primary capital ratio from 7.5 percent of assets to less than 6 percent.<sup>4</sup>

The Board also expressed concern about a regional holding company proposal which resulted

<sup>2</sup>The Central Bancorporation, Inc., "Federal Reserve Bulletin," (December 1982), pp. 789-792.

<sup>3</sup>The pace of interstate bank acquisitions could be affected if the Board does discount BHCs' capital by some fraction of its goodwill. This will be a problem because in most banking mergers the acquired organization received some premium over its book value. If the Federal Reserve does discount capital based on goodwill, then capital requirements for interstate expansion will be effectively increased.

<sup>4</sup>"Manufacturers Bancorp, Inc.," "Federal Reserve Bulletin," (January 1983), pp. 46-48.



in the holding company taking on substantial new debt, although its capital remained above the guidelines. The Board's comment on a southeastern regional BHC acquisition request was that "...although the proposal would entail significant acquisition debt, the amount of debt involved would not preclude the applicant from serving as a source of strength to its subsidiary banks.<sup>5</sup> The bank's total capital ratio dropped from 7.09 percent at the end of 1981 to a pro forma amount of 6.57 percent after the acquisition was consummated.

The Board has approved a bank acquisition request by a large multinational holding company. The Board said that, even though it has been concerned about "a long-term trend" toward lower capital ratios for multinationals, it "...has noted the improvements that Citicorp has made in its capital position...".<sup>6</sup> At the beginning of 1981, the holding company had a 3.6 percent primary capital ratio. The Board also expressed its expectation that the holding company will "continue its efforts to improve its capital position and will take such efforts into consideration in acting on applications for further expansion."

## Interstate Expansion of Community Banking Organizations

The community banking organization, as defined in regulatory guidelines, can be divided into small organizations and large organizations. The small community banking organizations, those with less than \$100 million in assets, constitute the overwhelming majority of banking organizations in the United States. These organizations are generally too small, however, to be a major factor in interstate banking. Most of these small organizations could double or triple in size and still have less than \$100 million in assets. Most interstate banking that these organizations engage in will be transacted through offices no more than a few miles from their headquarters.

The larger community organizations generally are similar to regional and multinational banking organizations, but there is one significant difference. The larger community banking organizations have an important motivation to grow, because a bank that grows to over \$1 billion in assets becomes a regional bank for capital

adequacy purposes. Community banking organizations that grow into regional organizations can meet the guidelines with .5 percentage points less total capital and 1 percentage point less primary capital. If the guidelines are taken literally a holding company with assets of \$950 million and the exact minimum total capital to classify as a Zone 1 community bank could finance the purchase of a \$51 million bank with debt and still emerge with total capital exceeding Zone 1 guidelines as a regional holding company. A similar but less dramatic effect would occur if the guidelines were administered such that as a bank grows towards its boundary, its capital requirement would approach that of larger banks.

In 1982, Golembe Associates studied the December 1981 primary and total capital ratios of a sample of Association of Bank Holding Company members.<sup>7</sup> The Golembe study looked at the association's 20 largest members, 60 percent of its members who have between \$3 billion and \$5 billion in consolidated assets and 25 percent with less than \$3 billion in assets. The results, reproduced in Table 1, show that most large community bank holding companies can support some asset growth on their existing capital.

Every percentage point a community holding company exceeds the total capital Zone 1 guidelines could support up to 14 percent asset growth.<sup>8</sup> Thus, some larger community organizations may be able to move up to regional bank status with little or no increase in their capital.

## Large Banking Organizations' Current Capital Position

Most interstate banking that will take place if restrictions are dropped will involve regional and multinational banking organizations. These organizations can support growth with their existing capital, the earnings they retain in the future and the new capital they raise. The asset growth to be supported, however, will not consist solely of

<sup>7</sup>See "An Analysis of the New Capital Guidelines for Bank Holding Companies," Golembe Associates, Inc., November 1982.

<sup>8</sup>If a banking organization is allowed to reduce its capital ratio (primary or total capital) to the minimum Zone 1 guideline, then it can grow by the amount excess capital/minimum Zone 1 capital ratio. A community bank with a 7 percent primary capital ratio could expand by a maximum of 7 percent - 6 percent/.06 = .14. This calculation of a banking organization's growth potential is for illustrative purposes and does not necessarily apply to any specific organization. Unique characteristics of individual banking organizations may affect the minimum capital ratios required for Zone 1 classification.

<sup>5</sup>"Ellis Banking Corporation," *Federal Reserve Bulletin*, (July 1982).

<sup>6</sup>"Citicorp," *Federal Reserve Bulletin*, (October 1982).



**Table 1.** Percentage Distribution of Capital Ratios of Sampled Community Holding Companies  
December 31, 1981

Capital as a Percent of Assets	Primary Capital	Total Capital	
5.0 - 5.5	10	—	Zone 3
5.5 - 6.0	10	—	
6.0 - 6.5	—	—	Zone 2
6.5 - 7.0	20	20	
7.0 - 7.5	20	30	
7.5 - 8.0	10	20	
8.0 - 8.5	20	20	
8.5 - 9.0	—	—	Zone 1
9.0 - 9.5	—	—	
9.5 - 10.0	10	10	

— Federal Reserve Board primary capital ratio guidelines.  
 - - - - Federal Reserve Board total capital ratio zones.  
 Source: Golembe Associates

interstate banking but also will come from the growth of existing business. Before we can analyze the ability of large banking organizations' capital to support interstate banking, we need to look at banking organizations' historical ability to generate capital to support their growth.

The analysis will be limited to regional and multinational bank holding companies. Independent regional banks are not analyzed because they constitute a small fraction of the regional banking organizations. There are no multinational banks that are not affiliated with a holding company. The capital position of individual banks within holding companies need not be a constraint on interstate banking because holding companies have the option of double leveraging to meet the capital needs of individual subsidiaries.<sup>9</sup>

Talley has examined the asset and equity growth rates of the multinationals banking organizations (Table 2).<sup>10</sup> He shows that the growth rate of equity capital at multinationals shifted up from around 7.5 percent in 1970-1974 to around 11 percent between 1975 and 1982 but that it has otherwise remained relatively stable. The growth rate of bank assets has fluctuated widely through the past decade, however, with a maximum annual rate of 25.1 percent and a minimum rate of 1.6 percent. The equity capital to assets ratios declined from 5.15 percent in 1970 to 3.49 percent in 1974 and thereafter have fluctuated between 3.6 and 4 percent.

Capital trends for a random sample of regional banks are presented in Table 3.<sup>11</sup> These organizations' equity capital has been relatively constant

<sup>9</sup>Double leveraging can be loosely defined as bank holding company debt issues that fund holding company purchase of bank equity. The new capital standards do not stop holding company double leveraging. However, they do prevent bank capital arising from double leveraging from being used to offset a weak BHC capital position. Therefore BHCs that meet or exceed the consolidated capital standards can use double leveraging to meet the capital needs of individual subsidiaries.

<sup>10</sup>See "Bank Capital Trends and Financing," by Samuel Talley, a Board of Governor's staff study in February 1983.

<sup>11</sup>The original sample consisted of 30 organizations that were regional BHCs on December 31, 1981. The sample is selected at random with replacement, as suggested by Lapin. The sample size is reduced to 29 because one BHC, a spinoff from a nonfinancial corporation in 1980, had to be dropped. Some of the banking organizations had less than \$1 billion in assets in one or more years prior to 1981 and some organizations were not organized as a holding company for the entire period.



over the sample period, particularly since 1977. Regional holding companies have raised their capital at a rate close to their growth rate in assets over the same period.<sup>12</sup>

The Golembe analysis of regional and multinational holding companies' primary capital is reproduced in Table 4. Almost all the regional holding companies sampled meet or exceed the Federal Reserve's primary capital standards. Smaller regional BHCs tend to exceed the standards by a larger margin than do larger regionals. Only half of the regional holding companies with over \$5 billion in assets exceed the capital standards by more than 1 percentage point, while 77 percent of the regional organizations with \$3 to \$5 billion in assets and 80 percent of the regionals with less than \$3 billion exceed the standards by more than 1 percentage point. Every 1 percentage point of primary capital above the guidelines at regional banks could support as much as 20 percent growth if accompanied by an appropriate increase in the organization's debt capital and if the Federal Reserve allows the holding company to reduce its capital to the minimum Zone 1 guidelines.

As noted above, no guideline has been given for multinational holding companies, but the Fed and Comptroller of the Currency have expressed a desire to see improved capital positions. Even given this desire, it is highly unlikely that the Federal Reserve can force multinationals to maintain capital ratios higher than those required of regional banks. Of the multinational organizations, 37 percent have primary capital equal to or greater than that required for regional banks.

The Golembe Associates study also examined the total capital position of their sample, and those results are reproduced in Table 5.

A substantial minority of the regional banks have total capital ratios in Zones 2 or 3. This stands in sharp contrast to the finding that virtually all regional banks have adequate primary capital. For those holding companies with total capital in excess of the minimum required for Zone 1 regional organizations, every percentage point of excess total capital could support as much as 15 percent asset growth.

No total capital standards have been specified for multinational organizations. If the categories

applied to regionals are also applied to multinationals, then no multinational has Zone 1 total capital and the overwhelming majority have Zone 3 total capital.

This analysis of current holding company capital positions demonstrates that smaller regional organizations are in a better position to support growth than larger organizations, and that regional organizations are in a better position than multinationals.

While no guidelines have been set for the multinationals, the Federal Reserve expressed its concern about the "long-term decline in capital ratios, particularly those of the multinational group," when it issued the standards in December 1981. Since that time banks have raised significant amounts of new capital.<sup>13</sup> In one case in October 1982 in which specific reference is made to a multinational's capital position, the Board noted improvements in the holding company's capital position and expressed its expectation that further improvements would be made.

This analysis also demonstrates that community and regional holding companies' primary capital positions are better relative to regulatory standards than are their total capital positions. Some regional organizations may be able to support up to 60 percent growth on existing primary capital if they increase their total capital by issuing additional subordinated debt or limited life preferred stock.

## **Will Capital Standards Slow the Growth of Interstate Banking?**

Large banking organizations have been able to provide capital sufficient to support some growth while maintaining primary capital ratios at a relatively constant level since the mid 1970s. Some regional banking organizations may even be able to grow by as much as 15 to 23 percent on existing total capital and by as much as 60 percent on existing primary capital if they raise additional subordinated debt or limited life preferred stock. If banking organizations want to expand beyond their existing capital base, they will have to sell more subordinated debt or preferred stock and take one or more of the following measures to increase their equity

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<sup>12</sup>The above analysis of equity capital trends ignored historical trends in total capital because the regulatory view of holding company subordinated debt has shifted through time.

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<sup>13</sup>See "Outlook for Bank Capital" by Jane F. Nelson in the December 1982 *United States Banker*.



**Table 2.** Equity Capital to Asset Ratio, Asset Growth and Capital Growth Rates for Multinational Banking Organizations

Year	Percentage Growth in Equity Capital During the Year	Percentage Growth in Total Assets During the Year	Equity Capital to Total Assets Ratio at Year-end
1970	7.9	10.9	5.15
1971	6.8	12.0	4.91
1972	8.0	19.7	4.43
1973	7.7	25.1	3.82
1974	7.9	18.2	3.49
1975	14.8 <sup>2</sup>	1.6	3.94 <sup>2</sup>
1976	10.2	8.5	4.00
1977	10.5	14.6	3.86
1978	11.4	14.2	3.76
1979	11.2	15.9	3.61
1980	13.0	10.5	3.69
1981	11.1	7.3	3.83
1982 (6 mos.)	11.1 <sup>3</sup>	2.7 <sup>3</sup>	3.98 <sup>4</sup>

<sup>1</sup> Based on consolidated bank holding data.

<sup>2</sup> The growth of equity capital and the equity capital to total assets ratio were increased in 1975 due to an accounting change.

<sup>3</sup> Annualized growth rate. The growth rate for total assets between December 31, 1981 and June 30, 1982, probably was reduced to some degree by year-end "window-dressing" that increases total assets. The growth rate of total assets from June 1981 to June 1982 was 3.9 percent.

<sup>4</sup> Ratio is for June, 1982.

Source: Talley

**Table 3.** Equity Capital to Asset Ratio, Asset Growth and Capital Growth Rates of Sampled Regional BHCs

Year	Percentage Growth in Equity Capital During the Year	Percentage Growth in Total Assets During the Year	Equity Capital to Total Assets Ratio at Year-end
1975	3.7	3.8	6.2
1976	7.9	5.9	6.3
1977	6.1	11.5	6.0
1978	10.5	12.8	5.9
1979	9.5	8.7	5.9
1980	9.4	7.3	6.0
1981	11.0	11.4	6.0

Source: FDIC, Moody's



**Table 4.** Percentage Distribution of Primary Capital Ratios of Sampled Companies by Class and Size of Company

Primary Capital as a Percent of Assets	Regionals: Assets Between \$1b-3b	Regionals: Assets Between \$3b-5b	Regionals: Assets Above \$5b	Multinationals
3.0 - 3.5%	5	—	—	—
3.5 - 4.0	—	—	—	19
4.0 - 4.5	—	—	—	38
4.5 - 5.0	—	—	—	6
5.0 - 5.5	10	18	6	25
5.5 - 6.0	5	6	44	6
6.0 - 6.5	25	24	25	6
6.5 - 7.0	15	29	19	—
7.0 - 7.5	20	24	—	—
7.5 - 8.0	15	—	6	—
8.0 - 8.5	5	—	—	—

— Federal Reserve Board primary capital ratio guidelines for "regional" holding companies.

Notes: No guidelines have been established for the multinationals.

Source: Golembe Associates

capital: raise new equity capital in the financial markets, use stock swaps to acquire other banks, increase their profitability, or cut their dividend payout ratio.

Bank organizations should face no special problems raising new debt capital. They may, however, have problems increasing their equity capital.

Assuming that banks cannot significantly increase their profitability, they will have to acquire banks through stock swaps, sell new equity or cut dividend payouts to raise new equity. Stock swaps will generally provide sufficient new equity to support the banking organization's growth. Nelson looked at banks' ability to sell new equity issues, but she did not consider dividend cuts. She notes that most bank stocks are selling below book value and that bank

capital problems may affect the pace of banking organizations' growth.<sup>14</sup>

Common market folklore has it that corporations whose stocks are selling below book value should not issue new stock because it will dilute existing earnings. Nelson expressed this view in a recent issue of **United States Banker**. "Selling new shares below book is damaging to the issuing institution because per share earnings can be severely diluted without a dramatic improvement in profits."<sup>15</sup>

The arguments that companies should not dilute earnings and should not sell stock below book value are suspect. When a company

<sup>14</sup>Nelson, *Ibid.*

<sup>15</sup>Horvitz also discusses the potential for bank mergers to result in the dilution of the acquiring firm's earnings.



**Table 5.** Percentage Distribution of Total Capital Ratios of Sampled Companies by Class and Size of Company

Primary Capital as a Percent of Assets	Regionals: Assets Between \$1b-3b	Regionals: Assets Between \$3b-5b	Regionals: Assets Above \$5b	Multinationals
3.5 - 4.0%	5	—	—	13
4.0 - 4.5	—	—	—	25
4.5 - 5.0	—	—	—	25
5.0 - 5.5	5	12	—	19
5.5 - 6.0	5	12	38	13
6.0 - 6.5	20	18	13	6
6.5 - 7.0	10	24	25	—
7.0 - 7.5	30	29	19	—
7.5 - 8.0	10	6	6	—
8.0 - 8.5	10	—	—	—
8.5 - 9.0	5	—	—	—

Notes: There are no zone designations for multinationals.

Source: Golembe Associates

purchases an asset, such as another bank or a *de novo* branch, it is buying a stream of future earnings. The asset is worth purchasing if the value of the future earnings discounted at the bank's cost of capital exceeds the cost of the acquisition or in other words the asset has a positive net present value.<sup>16</sup> If the cost of the acquisition is greater than the discounted value of the earnings, then the project has a negative net present value and is disadvantageous to existing shareholders. Short-term dilution of earnings is not harmful to shareholders if the acquisition promises sufficient earnings in the future. The relationship of book value to market

value is irrelevant to the calculation of an acquisition's net present value. Banking organizations selling below book value are doing so because they made investment and management decisions that were mistakes viewed with the 20-20 perspective of hindsight.<sup>17</sup> Banks cannot erase the effects of bad decisions by refusing to raise new equity to support desirable interstate growth. Indeed, bank management only compounds the cost to shareholders of prior mistakes if it refuses to fund growth that has a positive net present value.

<sup>16</sup>Banks' cost of capital is a weighted average of the rate paid on new debt and the market's required rate of return on a new stock issue with the weights depending on the firm's debt-to-equity ratio.

<sup>17</sup>This analysis of bank stocks that sell below book value applies to firms whose stock sells on organized exchanges. Because of liquidity problems, the stock price of banking organizations whose stocks have only a limited local market may not reflect the firm's true value. Thus a small bank's stock may sell below book value not because of bad management decisions but because too few investors know enough about the bank to buy its stock.



The other way to increase a bank's capital given constant return on assets is to cut the dividend payout ratio. Dividend payout ratios can be reduced by: cutting dividends or by maintaining constant dividends while income is increasing with the bank's size. The reluctance of bank analysts to suggest that banks could solve their capital problems by reducing dividends is not very surprising. Most corporations are very reluctant to cut their dividends, and those that do, such as Consolidated Edison, sometimes find that their stock price drops sharply after the cut. Often times, however, a company cuts its dividend while it is experiencing financial difficulty. A dividend cut by a firm in this setting is taken by the financial markets as a signal that the company's management thinks it has serious problems. Thus, it is not the dividend reduction per se that causes a firm's stock price to drop, but rather the indication it provides about future prospects.

Banking managers who reduce dividends to fund profitable interstate growth are not sending the market a negative signal. On the contrary, such reductions should indicate that management views a firm's prospects as very favorable. If the financial markets agree with management, then a dividend reduction will increase the value of an organization's stock.

Banking managers who believe dividend cuts will hurt their stock price can consider the less drastic measure of holding dividends constant while income increases. This is a slow way for a firm to increase capital, but it is better than foregoing profitable investments because of capital limitations.

Banking organizations, then, can increase equity capital to support profitable interstate growth and still increase the value of their outstanding shares. There are, however, several reasons why capital adequacy guidelines may slow the growth of profitable interstate banking.

One possibility is that banking organizations will follow conventional wisdom by refusing to cut dividends, pay out ratios or sell stock at prices below book value to support desirable interstate growth. If this happens and holding company stock prices do not increase, then capital adequacy standards will slow the development of interstate banking significantly.

A related reason why interstate growth may be slowed is that the financial markets may not agree with bank managers on which interstate expansions have a positive net present value. No matter how desirable a banking organization's management believes interstate growth is,

unless the financial markets agree with management's assessment the firm's stock price will drop. Therefore, some interstate expansions may be killed because the markets do not agree with management's assessments of their desirability.

Another problem that may slow the expansion of smaller banking organizations is that they may find the transaction costs of selling new equity so high that otherwise desirable mergers will become too expensive. Nelson quotes Harry Keefe, Jr., chairman of Keefe, Bruyette and Woods, as saying, "About 63 percent of all stocks are purchased by pension funds, and a company that can't reach that market is disadvantaged."<sup>18</sup> Keefe went on to point out that few banking organizations have sufficient trading volume to justify institutional interest. This disadvantage for smaller holding companies relative to larger organizations will be offset partially by their stronger capital position.

The fourth reason why capital guidelines may slow interstate banking growth is that they increase discount rate applied cash flows from growth. Banks, like all corporations, should discount their future cash flows by their cost of funds. Government regulation of capital/asset ratios increases banks' cost of funds if that regulation forces banks to hold more capital than they otherwise would and if equity capital is more expensive than debt.

## Conclusion

Regulatory capital adequacy guidelines can affect the rate of growth in interstate banking. Banking organizations that wish to grow must have sufficient existing capital or they will need to raise additional capital. While many community and smaller regional bank holding companies appear to have excess capital, the capital position of larger regional holding companies and the multinationals seems to be weaker. Low bank stock prices may inhibit some banking organizations from selling additional equity to support growth. Banking organizations' stockholders should be willing to raise sufficient capital to support interstate growth that has a positive net present value. Regulatory capital guidelines may prevent some questionable interstate expansion, but they should not prevent expansion of profitable interstate banking.

—Larry D. Wall

<sup>18</sup>Nelson, *op. cit.*, p. 47.





## Technology and Interstate Banking

*Interstate electronic banking is already emerging. In fact, in the near future virtually all financial institutions may gain access to networks that enable them to deliver services anywhere in the country.*

Delivering financial services to customers is the business of banking. Historically banks have delivered their services from their main offices and branches. A customer could gain access to his account indirectly, using the postal system or couriers; but transactions could not be processed and completed until a physical item (check, deposit, loan application or payment) arrived at an office of the customer's bank. Thus convenient locations and efficient transportation have been keys to banks' ability to attract and serve customers. And legislative restrictions on branching have limited the geographic markets in which banks could compete.

Today technology is changing the constraints on the delivery of financial services. Special-purpose computer terminal devices such as automated teller machines (ATMs) and point-of-sale (POS) terminals give customers direct access to their bank accounts from grocery stores, shopping malls and other nonbranch locations. Personal computers give customers access to their accounts from office or home. Transactions can be processed and completed through electronic signals that travel along telephone lines or two-way cables. Today a customer's bank may be as convenient as his television set. And banking's need for an efficient transportation system is being replaced by the need for efficient data communications.

Technology is reducing the need for branch offices and is introducing interstate banking for retail and commercial customers. On the commercial side, interstate banking is supported by loan production offices and calling officers. The support for interstate banking is not clear on the retail side. Nevertheless, a review of emerging retail electronic banking services reveals that the elements of interstate banking for consumers are being put in place.

In the case of ATM systems, the interstate connections are already being made. Technological feasibility and economic necessity support the addition of other services to the communication links already established for ATM systems,



reinforcing the trend toward interstate retail banking. A deterring question is how long the courts will continue to equate electronic banking terminals with branch banks. Nevertheless, de facto interstate retail electronic banking is already emerging, and it seems likely that legislation and regulation eventually will confirm what is already a fact.

## Elements of Retail Electronic Banking

Retail electronic banking services today are somewhat disjointed. The three services that most financial institutions consider as retail electronic services are ATMs, POS, and home banking.<sup>1</sup> Home banking's precursor, telephone bill paying, is a hybrid that may enable customers to access their accounts by interfacing directly with the bank's computer via push-button telephones, or it may require a bank employee to act as the interface between the telephone customer and the bank's computer. ATMs, POS and home banking services are at different phases of development. They are not linked together internally at most banks yet, and the number of banks that have joined in shared systems remains small. However, it appears likely that these three services eventually will be linked into an electronic delivery system banks can use to deliver financial services anywhere in the United States.

**ATMs.** Automated teller machines primarily provide exchange services. ATM deposit, withdrawal and transfer capabilities enable customers to exchange one form of asset for another. For example, they can exchange deposits in a bank account for cash. Some ATM systems also enable customers to make payments to credit card accounts or loans, and some permit credit card cash advances. However, ATMs' payment and credit functions are seldom used. They account for less than 2 percent of the transactions conducted on these machines. As of 1982, cash withdrawals were the most popular type of ATM transaction (76 percent of transaction volume), followed by balance inquiries, an information service delivered via ATMs.<sup>2</sup>

**POS.** Point-of-sale services are not widely available and the product itself is not clearly defined. One or more of four services generally are associated with POS: (1) check authorization/guarantee, (2) credit authorization, (3) point of banking and (4) direct debit.

Check authorization/guarantee and credit authorization services are self-explanatory. Point of banking is the term the banking industry applies to delivering deposit, withdrawal, transfer, payment or information services to bank customers via terminals in retail locations. Usually the terminal transmits data to the customer's financial institution and receives authorization for the transaction from that bank. A clerk at the retail location completes the transaction by accepting deposits and payments and dispensing cash.

Direct debit represents the POS concept in its purest form. In a POS system featuring direct debit, a customer can pay for purchases electronically, using a terminal to authorize his bank to debit his account and credit the merchant's account for the purchase price.

The few direct debit POS services available have won little acceptance from consumers. Most of the service's benefits seem to flow to merchants and banks, who favor the concept because it can reduce operating costs. The principal benefit to consumers is convenience and ease of use. (For example, the Iowa Transfer System's POS pilot service has found that direct debit transactions are handled even faster than cash.) Also, consumer record-keeping might be made easier because of documentation in periodic statements and terminal receipts. Nevertheless, debit cards must compete with checks and, in some instances, with credit cards; and consumers find these traditional payment mechanisms relatively easy and inexpensive to use. It seems likely that banks and merchants will have to add incentives such as merchant discounts before consumers will be converted to this new payment mode. It is also likely that rising costs of checking and credit card services will encourage consumers to try direct debit services if they are priced lower than the alternatives.

**Home Banking.** The retail financial service of the future is home banking, but it is not an

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<sup>1</sup>Direct deposit of social security and payroll checks and preauthorized payments made through an automated clearinghouse (ACH) are also quasi-electronic ways of processing retail account transactions. However, the company or the government generally initiate these transactions based on a written authorization from the retail account holder. Since these are consumer initiated retail electronic banking transactions are not discussed further in this paper.

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<sup>2</sup>Linda Fenner Zimmer, "ATMs: Time to Fine Tune and to Plan," *Magazine of Bank Administration*, May 1982, p. 21.



entirely new idea. The first example of a home banking service was Seattle First National Bank's "In Touch" service, which permitted customers with push-button telephones to access the bank's computer for a variety of services such as budgeting, an electronic calendar, a calculator and bill paying. In Touch was a case of too-much-too-soon, and the Touch Tone telephone proved inadequate for delivering the multiple services in a way that consumers related to well.

The remarkable acceptance of personal computers and the capabilities of videotex technology have shifted home banking's emphasis away from the telephone. Delivering banking services to customers' personal computers or home terminals offers a wider variety of services, a greater sense of control, and a simple extension of the financial management applications already familiar to personal computer users.

Banks taking leadership positions in the home banking movement tend to operate as financial gateways between the home information/transaction systems, in which they may or may not have an ownership interest, and other financial institutions. The gateway links a consumer with his bank. To conduct banking transactions, a consumer accesses his home information/transaction service from his home terminal and enters a code indicating he wants to access his bank. This code links the customer up with the financial gateway that services his bank, and the gateway links the consumer with his financial institution (Figure 1).

Home banking services have tremendous potential to foster interstate retail electronic banking. Home information/transaction services operate nationwide, but they permit customers to gain access to the systems via a local telephone call. For example, both Compuserve and The Source have local access telephone numbers in hundreds of cities. A consumer wanting to deal with a bank associated with one of these services could dial a local number to link up with his bank's computer regardless of his location.

### **The Emergence of Nationwide Shared ATM Networks.**

Automated teller machines are the first of the retail electronic banking services to achieve market success. The dismal history of POS systems suggests they were an idea born too soon, and home banking is still predominantly in

an experiment phase. It took ATMs more than a decade to catch on with consumers, but now those machines seem to be leading the way into an interstate retail electronic banking system.

At the outset, few ATM networks were shared. Financial institutions sought competitive advantages through their ATM systems, believing ATMs were capable of shifting market share. As all major competitors in a marketplace came to have ATMs, each sought to differentiate its ATM service and to maintain a unique association with its particular ATM access card.

Larger financial institutions were usually the first to offer ATM services, and they put smaller banks at a competitive disadvantage. Small banks in some market areas began to develop shared ATM systems, in which customers of one bank could use another participating bank's machines. Most shared ATMs were located in the main offices and branches of participating banks, but many state legislatures came to the aid of small institutions by implementing mandatory sharing laws in the name of competitive equality.

As ATMs became more popular among bank customers, the bankcard associations, VISA and MasterCard, made their moves. Each association enabled its members' cardholders to access the ATMs of all banks participating in their respective ATM networks.

This prompted a flurry of response in the banking industry.<sup>3</sup> Large banks feared they would lose the competitive advantage of proprietary ATM programs if their VISA and MasterCard customers could go to a competitor's ATMs for cash withdrawals. Value would be added to the bank credit cards, but few customers associate their VISA and MasterCards with a particular bank.

### **The ATM Network Debate**

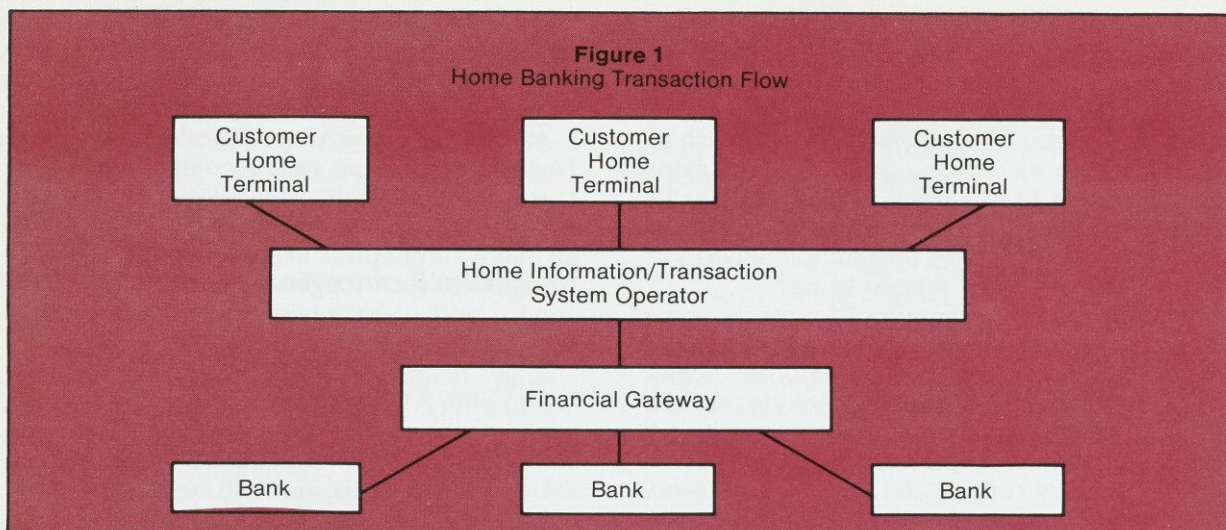
The appropriate ATM network structure is an issue of considerable debate. The organizations planning to offer national network switches disagree as to what the banker wants from a network. Some say exclusivity is primary to a banker's choice of network. The network operators seem to be trying to find a middle ground between proprietary and shared ATMs. Cirrus and Plus, for example, grant exclusive marketing

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<sup>3</sup>See "ATM Networks: the Nation & the Southeast," *Economic Review*, Federal Reserve Bank of Atlanta, January 1983.



**Figure 1**  
Home Banking Transaction Flow



territories to their members. This lets members limit availability of the shared services by marketing participation in them to only those institutions with which they wish to share.

Other bankers and network operators reject the exclusivity hypothesis. They feel that ATMs are fast becoming a "generic" service that does not lend itself to successful exclusive sharing. The "generic" viewpoint contends that nationwide servicing soon will be an industry-wide phenomenon, not a major selling item for any single institution. According to this view, product differentiation will remain important to consumer banking but should be carried out in ways other than exclusive nationwide sharing.

Citibank epitomizes a third point of view. Citibank has outlined tentative plans for a proprietary national ATM network, but does not expect to proceed until banking laws are amended to allow interstate deposit-taking. Officials at Citibank see nothing to be gained by participating in networks today.

### The Integration of ATM and POS Systems

Shared ATM networks seem to be contributing to the resurgence of interest in POS services. On the surface, this renaissance seems unfounded. POS systems have a history of failure. Those still operating cannot be considered resounding successes. And consumer survey data suggest that people are at best disinterested and at worst opposed to direct debit services at the point of sale. However, when POS is considered from the perspective of technological feasibility the recent

wave of new POS experiments begins to make sense.

The heart of a POS system is the switch. The switch is the device that transfers messages arriving from POS terminals to the appropriate financial institution or data processor for handling, and transmits the response back to the terminal from which the message originated. The heart of a shared ATM network is also a switch, and it serves the same function as a POS switch. Furthermore, a switch can be configured to receive messages from a wide variety of terminal devices. Thus a single switch can serve ATMs as well as POS terminals.

A key attraction of POS services is the number of transactions they could contribute to a switching system if the services are successful. Most transactions an ATM switching system could expect to handle would be the functional equivalent of checks written for cash. In 1979 only 8.15 percent of the checks written by consumers were for cash. In contrast, 32.22 percent of consumers' check were written to pay for purchasers at the point of sale.<sup>4</sup> Clearly, then, POS services have the potential to generate considerably more volume than ATM services. Some shared ATM systems may even *require* the additional volume that a successful POS service could provide to achieve the economies of scale that will make retail electronic banking cost effective. In sum, the integration of shared ATM

<sup>4</sup>Consumer Checking Accounts: Debits, Credits, and Balances, p. 8.



networks and POS systems seems almost inevitable, and nationwide ATM networks presage nationwide POS.

## **The Legal Environment for Interstate Retail Electronic Banking**

While technology makes interstate retail electronic banking feasible, the legal environment is less favorable. The legal question is whether ATM and POS terminals are branch banks.

The American Bankers Association has drafted proposed legislation, dubbed the EFT Systems Act, which may help smooth over the ambiguities of EFT law. This legislation would follow the recommendations of the National Commission on Electronic Fund Transfers (NCEFT) and make a clear distinction between brick-and-mortar branches and ATM terminals. It would permit deposit-taking across state lines in "natural market areas," defined as either SMSAs or "that area where a financial institution services current deposit customers across contiguous state lines." State laws covering EFT terminal deployment would be preempted, although states would have the option to exempt themselves from the law within three years.

To date, however, the ABA has not been successful in soliciting congressional interest in the bill, and the industry is proceeding cautiously toward interstate retail electronic banking.

In sum, the legal status of ATM and POS terminals remains hazy. This ambiguity is hindering, but not halting, the trend toward interstate retail electronic banking. Financial institutions are participating in shared ATM networks based on the Comptroller's distinction between establishing an ATM and using ATMs established by another financial institution. Nevertheless, the ATM networks are being used for cash-dispensing purposes only. They are not taking deposits across state lines. One might expect, then, that interstate POS systems, when established, would be used for direct debit but not point-of-banking, since deposit-taking is part of the point-of-banking concept.

## **Conclusion**

The elements of an interstate retail electronic banking system are being put in place. Technological feasibility and economic imperatives are encouraging efforts to integrate the elements into a more comprehensive whole. And the hazy

legal status of a shared nationwide system is playing a restraining role. It is general wisdom, however, that the law moves slowly and tends to confirm changes that have already occurred.

A change in financial institutions' behavior regarding retail electronic banking systems suggests that an interstate system will evolve. The change can be seen in the parallels between shared ATM network developments and developments in the home banking arena. In both instances large financial institutions are showing a willingness to cooperate in establishing systems they once would have viewed as proprietary competitive tools.

It also has become apparent that the key technological element in ATM, POS and home banking systems is the switch. Eventually all three services may operate through the same switch. Even though ATM and POS terminals are not based on the videotex technology that underlies today's home banking experiments, a single switch could be designed to support both technologies.

It appears that the financial services industry is coming to see the three elements of retail electronic banking as a set of similar delivery mechanisms for services rather than as a set of services in and of themselves. As the perception of EFT as a delivery mechanism becomes clearer, systems will begin to integrate and interconnect.

Nevertheless, it seems unlikely that all of these networks, pilots and systems will be successful. It is reasonable to believe that consolidation will occur among ATM and POS networks and among home information/transaction systems as well. Less successful networks and systems probably will merge with their more successful counterparts.

What seems likely to emerge over the long run is a small number of competing ATM, POS and home banking networks with the capacity to serve all banks that wish to provide retail electronic banking services to their customers, wherever they may be. As all financial institutions gain access to networks that enable them to deliver services anywhere in the country, the branch/terminal issue and the definition of competitive equality on a state-by-state basis will become meaningless. De facto interstate retail electronic banking may then, finally, be confirmed by law.

—**Veronica M. Bennett  
and Charles R. Haywood**





# The Canadian Experience with Nationwide Banking

Throughout Canada's history as a nation Canadian banks have been permitted, indeed encouraged, to compete on a nationwide basis. Several massive multinational banking organizations dominate the Canadian landscape. Their huge branch networks provide large, stable Canadian banking operations to which have now been appended extensive international financial operations.<sup>1</sup>

Does the Canadian experience with "interstate" (or nationwide) banking contain any lessons which might be useful to the debate underway in the United States? The purpose of this paper is to search out answers to this question. It is important to note that any appreciation of insights, implications or analogies that might be drawn must be tempered with an awareness of the forces that have shaped the Canadian system and a realization that, as the United States liberalizes its interstate banking restrictions, it starts from a very different legal and economic footing than did Canada.

## Legal Environment

As might be expected, the evolution of Canada's banking system has been profoundly influenced by Canadian banking legislation. In Canada this means federal legislation. Section 91 of Canada's Constitution Act of 1867 conferred on the federal government exclusive power to make laws about banks and banking.<sup>2</sup> This authority has been exercised, where privately owned banks are concerned, by means of the Bank Act. The Bank Act requires any business wishing to call itself a bank or describe its business as banking to incorporate as a bank chartered under the Act. (Hence the commonly used term "chartered banks.")

The first Bank Act, passed in 1871, and all subsequent versions of the Act,<sup>3</sup> have empowered Canadian banks to open branches without restriction on their number or geographical location

<sup>1</sup>On December 3, 1981, total Canadian bank assets amounted to \$350 billion. Assets of the largest bank, The Royal Bank of Canada, at \$88 billion amounted to 25 percent of the total. The six largest banks held, together, \$330 billion or 94 percent of the total. About 40 percent of total banking system assets were foreign currency assets and the remainder or about \$200 billion were booked in Canadian dollars. The dominant relative position of the large Canadian banks has recently changed dramatically in terms of numbers of banks if not in asset size. In November 1980 there were

eleven Canadian banks operating. By December 1982 the number had risen to sixty-eight banks, of which fifty-seven were foreign banks subsidiaries. This article confines its attention to Canadian owned (or Schedule A) banks (see Box).

<sup>2</sup>Canada, Statutes, Constitution Act, 1967. Part VI, Section 91.

<sup>3</sup>Unless extended by the Canadian parliament the Bank Act must be revised or amended every ten years. Bank Act, Part I, Section 6.

*Under nationwide banking, Canadian consumers have enjoyed high quality and a wide variety of bank services while sacrificing some degree of local specialization. The Canadian system offers an interesting example of some advantages—and some potential dangers—of nationwide banking.*



(See Box). The rationale for this provision is unclear. It is consistent with the attempt of the federal government at the time of Confederation, in 1867, to pursue policies designed to bind the far flung regions of Canada together. Branch banks may have been viewed as facilitating the economic development of frontier areas as well as providing a national presence in the form of a nationally chartered bank. A more cynical approach might interpret the Bank Act as an example of successful, self-serving lobbying by branch banks which existed at that time.<sup>4</sup>

## Evolution of Large Scale Banks

Regardless, the effect was to permit banks to exploit banking opportunities by marketing their services on an unrestricted intra- and inter-provincial basis. The observed consequence was the rapid development of a highly concentrated branch banking system. Table 1 shows how the number of banks and branches in Canada have changed since 1870.

Not all federally incorporated banks operate national branch banking systems. Of the eleven banks that existed in 1980, the five smaller institutions are specialized in the geographical market or product lines they offer, thereby carving out their own "niche" relative to the larger banks. Three of the five concentrate their activities in western Canada and one in Quebec. All have been incorporated since the 1950s.

The six largest existing banks all have corporate histories which go back to the 1870s or before. They have evolved through a continuing process of progressively extending their size and geographic reach by expanding their network of branches through acquisition of competing banks with competing branches or by setting up new branches as the geographic frontiers of the national market expanded. For instance, between 1913 and 1930 twelve bank mergers took place while the number of branches skyrocketed.

The high degree of concentration in Canadian banking may also be attributable in part to provisions in the several Bank Acts other than those permitting mergers and unfettered branching. Orr, and Dean and Schwindt, in separate studies

### Box

#### Branching: Schedule A vs. Schedule B Banks

The absence of restrictions on bank branching activities of Canadian banks was unqualified prior to 1980. In November 1980 a new Bank Act was passed which created a new class of banks. Previously the names of all banks incorporated under the Bank Act had been listed along with pertinent corporate details in Schedule A of the Bank Act. The 1980 Bank Act permitted the incorporation of a new type of bank which would be listed not in Schedule A but rather in another schedule, Schedule B, of the Act. It is now conventional to distinguish between "Schedule A" and "Schedule B" banks.

Whether a new bank incorporated after November 1980 is classed as a Schedule A or B bank depends on how widely held are its voting shares. If any shareholder and associates hold or acquire more than ten percent of a bank's outstanding voting shares it is classed as a Schedule B bank. The distinction is crucial since Schedule B banks are restricted in size—to assets not more than twenty times authorized capital and are limited to two offices in Canada, a head office and one branch, unless additional branches are approved by the Minister of Finance. *De novo* banking subsidiaries of foreign banks are thus Schedule B banks and are subject to these asset and bank requirements along with other restrictions which do not apply to Canadian owned Schedule B banks. Foreign bank subsidiaries incorporated by the conversion of "nonbank" financial businesses operating branches prior to November 1980 are permitted to continue to operate those branches. New branches must, however, be approved.

In contrast, Schedule A banks, which include all banks operating as of November 1980 and new banks with widely held shares, are subjected by the Bank Act to no restrictions on asset size or branching activities.

The government's policy with respect to approval of applications for new branches by Schedule B banks is not known at this time.

of competition and concentration in the Canadian banking system came to the conclusion that the low rate of entry may be related as well to cumbersome incorporation procedures and requirements.<sup>5</sup>

Whatever the barriers to entry are, if they exist and impinge on incentives to establish new banks, existing banks will try to pick up any unsatisfied demand for banking services by substituting a branch in the appropriate location. In fact, branches in Canada were often set up in locations which might not offer sufficient incentive to induce a new bank to enter the market-

<sup>4</sup>R. Craig McIvor (1961), Chapter IV. McIvor's analysis of various versions of the Bank Act suggests the government was very responsive to suggestions by banks for amendments to the Act. More recently, Stewart has argued the

Canadian banks were effectively the designers of the early Bank Acts. Stewart (1982). See especially pp. 48-51.

<sup>5</sup>Orr, 1974, p. 97; Dean and Schwindt, 1976, p. 29.



**Table 1.** End of Year Data

	Number of Operating Banks	Number of Branches	Thousands of People per Branch
1870	34	123	28.9
1890	41	426	11.3
1910	28	2,367	3.0
1930	11	4,083	2.5
1950	10	3,679	3.7
1970	9	6,199	3.5
1980	11	7,414	3.3

Sources: Neufeld, E.P., *The Financial System of Canada*, Macmillan 1972, Tables 4:1 and 4:7; C.B.A., *Bank Directory of Canada*, 1981; Statistics Canada, *Canadian Statistical Review*, January 1983, Table 1.

place. Many branches were not immediately profitable.

Generally speaking, a new branch is expected to start earning a profit within three to five years and will not be opened unless there are good reasons to believe that this will be accomplished. If a branch shows persistent losses in spite of skillful management and vigorous efforts at business development, it will be closed.<sup>6</sup>

The enthusiasm of Canadian banks for branches as a method of competition (and, presumably, Canadian residents for bank services at convenient locations) has resulted in a very high ratio of branches to population. The United States, with roughly ten times Canada's population and five times the number of bank branches, has a branch density per capita of about one half Canada's.<sup>7</sup>

An interesting possible consequence of being so "heavily branched" has been the slow injection of ATMs into the banking system. In 1982, the density of ATMs per capita in Canada was about one third that of the United States.<sup>8</sup> This is evidently interpreted by Canadian banking people as evidence that Canadians are being well served by traditional branch banking systems and hence there is less incentive to speed ease of access to bank services by way of automated systems.<sup>9</sup> An alternative rationale could be that banks are reluctant to speed the obsolescence of their huge investment in branches and associated

systems of delivering banking services, at least until it is clear the public can be educated to accept lower branch densities in the future.

## Nonbank Deposit Institutions—The Competition

The banks are not without major domestic sources of competition in Canada. As we previously noted, institutions other than banks are not permitted to refer to themselves as banks or their business as banking. But the Bank Act fails to define what constitutes a bank or banking from a functional point of view. Thus, in Canada many businesses do provide banking services. They simply refrain from calling themselves banks or advertising their activities as involving banking.

This state of affairs has encouraged many organizations, especially trust companies and credit unions, to offer banking-type financial services to the general public. These include personal and mortgage loans, checkable and non-checkable savings deposits, credit card devices and so forth, offered in direct competition with the banks. The relative importance of these nonbank deposit institutions is suggested by their considerable aggregate size. At the end of 1981 the total assets of trust and mortgage loan companies amounted to \$65 billion, and those of credit unions—\$33 billion or close to \$100 billion together.<sup>10</sup> This was very close to one half of the Canadian dollar total assets of the chartered banks of \$202 billion. However none of the nonbank deposit institutions are nearly as large as the major banks.

Just as the banks branch within and among the provinces, so do these competing institutions. Table 2 shows the provincial distribution of branches of banks, trust companies, and local credit unions.

Nonbank deposit institutions may be incorporated at either the federal level or by a province. Though the Constitution Act gave the federal government authority over banks, Section 92 of the same Act gave provincial governments the power to incorporate businesses with "provincial objects." So, depending upon whether a trust company or a consumer or mortgage loan company, for example, intends to operate mainly with a

<sup>6</sup>Canadian Bankers' Association, 1963, p.83.

<sup>7</sup>Branching may be carried to excess. See, for example, Lawrence White, "Price Regulation and Quality Rivalry in a Profit Maximizing Model," *Journal of Money, Credit, and Banking* February 1976, p. 97.

<sup>8</sup>Sinclair (1982), p. 7

<sup>9</sup>*Ibid.*

<sup>10</sup>Bank of Canada, *Review*, February 1983, Tables 39, 40 and 7. Canadian banks are not permitted to offer trust services.



view to the national market, as opposed to the provincial market, it would incorporate under federal rather than provincial legislation, respectively.<sup>11</sup>

In terms of jurisdiction of incorporation these options lead to complex patterns of competition within a particular province. For example, in Ontario, at the end of 1980, the several hundred trust company branches indicated by Table 2 were operated by twenty trust companies incorporated in Ontario, fifteen trust companies incorporated in other provinces but registered for operation in Ontario, and twenty-three federally incorporated trust companies. Functionally speaking, the regulation of banking in Canada is a jurisdictional swamp.

### Geographical Uniformity of Price and Product

Canadian households and business firms who patronize the banks are faced with a geographical standardization or uniformity in the costs, qualities and types of banking services. Within each of the major banks, rates of interest on deposits and loans and service charges and fees are set by the head office and are the same whether you are banking at a branch in Halifax or Vancouver—4,000 miles apart.

The high degree of uniformity is not simply designed by the head office to reduce the cost of delivering bank services throughout the country. Canadians are highly mobile and normally can be expected to continue banking at the same bank as they move for whatever reason about the country. Thus it is good business for a nationwide branch bank to develop strong product loyalty among its customers. The battle for market share has new dimensions in the absence of geographical restrictions on delivering bank services.

Standardization can also pose a variety of problems for large branch banks. Where the opportunity exists it may be costly or simply not feasible to differentiate their product by geographic location. An advertising campaign geared

to appeal to the prairie provinces could not, for example, imply the bank has more to offer the population of those provinces than other regions of Canada.

Moreover, whether the criticisms are valid or not, Canadian banks are often perceived as insensitive to the needs of particular types of bank customers. A recent study observed that, while not a problem for most small businessmen, there is evidence that suggests Canadian bankers are generally less well trained, and have less experience and familiarity with the small businessman's situation than in many other countries.

This situation arises partly because of differences in bank structures in the various countries, with Canada's commercial banking industry representing an extreme case of large, far-flung branch banking organizations, which has certain implications for staff development. For example, such a structure creates a demand to recruit and develop generalists, who are equipped to provide a broad range of services in any type of geographic or economic environment.<sup>12</sup>

One aspect of Canadian banking stands out as being a clear and uniform benefit to all Canadians partly because banks operate nationwide. It is the check clearing system. Almost a century ago, in 1891, the Canadian Bankers' Association (C.B.A.), of which all banks were members, was given authority to operate clearing houses to handle payments instruments (mostly checks) moving among the banks. Only banks were members of the C.B.A.<sup>13</sup> Over the years an extraordinarily effective and convenient set of check processing practices and standards evolved which, in recent years, has meant for bank customers same day credit for deposited checks along with twenty four hour check clearing on a nationwide basis. This is particularly remarkable in the light of the number of checks being processed—nearly 1.6 billion in 1981.<sup>14</sup>

Because Canada's banking system is so uniform and highly integrated geographically, there is no possibility of achieving provincial or regional differences in monetary policy using the general

<sup>11</sup>Of course the specific requirements of the legislation will be different in the federal than in the provincial legislation and could influence the jurisdiction under which a company chooses to incorporate. Local credit unions having by definition local (or intra-provincial) purposes are incorporated or "certified" under provincial legislation. The national association of provincial credit union associations (the Canadian Cooperative Credit Society Limited) is incorporated under federal legislation.

<sup>12</sup>Canadian Federation of Independent Business (1982), p. 49.

<sup>13</sup>In November 1980 the Act incorporating the Canadian Bankers' Association was amended to remove responsibility for the clearings system from under

the wing of the Bankers' Association. Simultaneously new legislation setting up the Canadian Payments Association was enacted. The Canadian Payments Association will henceforth oversee the future evolution of the payments system in Canada. Under the earlier check clearing system, payments instruments of nonbank institutions were accepted on a fee for service basis. Under the Canadian Payments Association, which began operating in January 1983, banks, who must belong, and nonbank deposit institutions who choose to join, participate as full partners in the operation and administration of the check clearing system.

<sup>14</sup>Sinclair, *ibid.*, p. 3.



**Table 2.** Provincial Distribution of Branches of Banks, Trust Companies and Local Credit Unions (End of 1981)

Province	Banks	Credit Unions	Trust Companies
Newfoundland	154	22	14
Prince Edward Island	33	13	7
Nova Scotia	250	123	47
New Brunswick	181	133	22
Quebec	1,455	1,843	137
Ontario	2,849	1,157	599
Manitoba	360	228	34
Saskatchewan	394	343	49
Alberta*	811	291	125
British Columbia	862	296	122
Yukon	13	—	—
Northwest Territories	16	—	—
Canada	7,378	4,449	1,156

\*Data for Alberta do not include 113 branches of the Province of Alberta Treasury Branches. A unique provincial government institution formed in 1939, it is equivalent to a state bank and competes with the major banks within Alberta with a full range of banking services.

Source: Statistics Canada, **Financial Institutions, Third Quarter 1982**, January 1983, p. xxx.

instruments of policy.<sup>15</sup> This is, from time to time, a sensitive policy issue given the considerable differentials that have historically existed in provincial and regional economic performance and well being.

### Nationwide Utilization of Funds

Canada's national banks facilitate efficiency in the use of financial resources within Canada.<sup>16</sup> The overall capacity of the banking system to support deposits and to provide credit is roughly set by the Bank of Canada, but the distribution of these deposits and loans across the country depends primarily on the needs of bank customers. The whole national deposit base of each bank is available at standardized terms and conditions to borrowers regardless of their geographical location. The federal government

was correct over a century ago to view nationwide banks as a method of promoting the economic development of a nation.

However, this approach to the role of the banks works best if people in the various provinces and regions are able to perceive, for example, some advantage to having loans evaluated on the basis of a bank's national standards of credit worthiness rather than on terms and conditions especially designed to encourage loan expansion in their particular area. In Canada there has been persistent concern that what might be in the best interest of the nation is not necessarily in the best interest of a given province or region.

The latest evidence of this type of concern took place in the early 1970s. The governments of the western provinces, especially British Columbia, asserted that the activities of the national banks were deleterious to the economic health of the region. They claimed these banks were draining funds from their provinces for use in central Canada. The attendant debate showed that the assertion could not be supported by bank provincial deposit and loan data. But more than that it was apparent that there were (and no doubt continue to be) misconceptions about how branch banks influence geographical flows of funds.<sup>17</sup> In particular, it is not sufficiently appreciated that banks themselves initiate very little movement in funds among their branches. Instead, individual, local, provincial and regional deposit and loan ratios should be interpreted as representing the complex result of a multitude of factors related to supply and demand conditions encountered by the branches.<sup>18</sup>

### Nationwide Banking—A Good Idea for Canada

The policy of not imposing geographical restrictions on the domestic activities of Canadian banks has had certain unattractive consequences. Most striking is the potential that exists for a government-condoned lack of competition

<sup>15</sup>One obvious advantage to nationwide banking is inefficiencies in cost management associated with the handling of interregional deposit transfers. Many transfers that might give rise to liquid asset adjustment in a geographically restricted system can be handled as an internal bank book-keeping entry in the Canadian system. It is not clear, however, that these efficiencies may not be realized with a less concentrated system than that in Canada.

<sup>16</sup>At the same time because of the small number of banks that operated in

Canada, for many years, moral suasion was often used by the monetary authorities to influence the behavior of the banks. Examples include the imposition of a secondary or liquid asset reserve requirement in 1956 and of ceilings on certain term deposit rates in 1972.

<sup>17</sup>Benson (1978), pp. 57-76.

<sup>18</sup>For a detailed discussion of the effect of banks on the interregional movement of funds see Galbraith (1963), pp. 165-214.



among the banks coupled with the possibility that resource costs due to high branch densities are unnecessarily high. One's concern cannot help but be compounded by such considerations as the fact that banks are not covered under Canadian anti-combines legislation and that, until 1967, the banks were not prohibited from making inter-bank agreements on interest rate levels and service charges. Nor does the literature on economies of scale make one sanguine that the cost advantages accruing to a \$60 billion bank are likely to be significantly greater than those enjoyed by each of four \$15 billion banks. That these sorts of concerns might be justified was the tenor of a 1976 study by the Economic Council of Canada, in one of the more careful recent analyses of the profitability of Canadian banks, which concluded:

There is little doubt that present bank legislation gives rise to costs to Canadian customers. While these costs are in part a transfer from users of bank services to government and bank shareholders, the waste component of the costs may not be negligible. The higher prices charged for financial services will necessarily cause households and firms to fill their needs for these services by inferior methods. Thus there is a case for increasing the incentives to greater efficiency and for reducing operating costs and prices in Canadian banking.<sup>19</sup>

These disquieting aspects of Canadian banking must, however, be weighed against a variety of benefits that appear to accrue to the major banks. Nationwide banking permits the achievement of a degree of diversification of risk, geographical and otherwise, and a stability of operation that enable Canadian banks to compete successfully on a worldwide basis.

Perhaps a more important issue than the adequacy of the present or past structure of the banking system concerns whether it will serve Canadians well in the future. The 1980 Bank Act opened up the legislative door to Canadian banking more than in the past. The trend in Canadian banking is towards a more competitive environment. Coupled with the already high quality and variety of banking services available, nationwide banking will, I think, become increasingly easy to support as time goes by.

For the United States the challenge is to pursue those benefits that interstate banking is likely to yield while protecting itself from undesirable levels of concentration in the banking system. The Canadian experience suggests this might best be achieved through legislative changes that encourage competition within, as well as across, state lines. Those institutions capable of offering products or services more nicely tailored to suit local, state or regional tastes should have the freedom to compete on an equal basis with those banks that choose to offer a standardized product on a wider geographical basis.

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<sup>19</sup>Economic Council (1976), p. 47. A more recent but less well executed study came to the conclusion that bank profits in 1981 were consistent with those of a reasonably competitive and efficient banking system. See Senate Committee on Finance Trade and Economic Affairs, 1976.

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## Trade Groups Choose Sides

Regulation in the banking industry focuses on three specific goals: (1) to ensure stability in financial markets; (2) to prevent undue concentration of market power; and (3) to guard against sharp or unfair dealing.<sup>1</sup> The McFadden Act and the Douglas Amendment were intended at least in part to address these aims. The prohibitions on interstate banking were based on the belief that restricting the geographic scope of banking organizations would ensure sound and competitive banking practices. McFadden and Douglas served to erect a "fence" around each state, protecting banks within its boundaries from the rigors of outside competition. By locking competitors out, Congress sought to assure a large number of relatively small banks, thus ensuring a competitive market environment.

Competitive conditions in financial markets have changed considerably since McFadden and Douglas. Although the issues involved in the interstate banking debate are roughly the same, the market realities of the day are not. The relaxation of interstate restrictions on branching and interstate banking have become controversial

issues with bankers. Some say that the existing regulatory framework is outmoded. Many are also concerned with the deregulation of product lines to place all financial institutions on an equal footing. Can regulations that restrict only some of our financial institutions serve their intended purpose in a rapidly changing financial world? This article briefly outlines how several banking industry groups have positioned themselves on the interstate debate.

Some within the banking industry believe that product deregulation alone will produce parity with the nonbank institutions. Competing with the money market funds, Sears Roebuck, and other financial service companies, they believe, depends on the array of financial products they may offer, and not necessarily on the ability to accept deposits across state lines. The new product offerings made possible through deregulation would not be limited by state boundaries and, hence, would place banks on more equal footing with other types of financial service suppliers.

Supervision is another critical issue in the interstate banking scenario. If federal legislation liberalizes McFadden or Douglas, some observers worry, state banking agencies could see their authority preempted. A state supervisory agency tempers the scope of privilege granted by federal law to the particular needs of its state. Therefore, some regulators and

<sup>1</sup>Charles F. Haywood, "Regulation, Structure and Technological Change in the Consumer Financial Services Industry," *The Costs and Benefits of Public Regulation of Consumer Financial Services*, (Cambridge: Abt Associates, Inc., 1979).

*Banking industry interest groups will have a substantial influence on the evolution of legislation regarding interstate banking. The major trade groups often disagree, but their positions apparently overlap enough to point toward some sort of compromise.*



some of the regulated are likely to oppose any modifications to the existing legal framework that would lessen the states' ability to regulate their own financial marketplace.

There is considerable concern over excessive concentration of financial resources. Many feel that, in the absence of the protection afforded by McFadden and Douglas, small banks would face unfair competition from large out-of-state banks. Some charge that a large money center or regional bank might not be concerned with their community and that its development would suffer as a result. In this view, the local banker who is more attuned to the community's credit needs would be more likely to make the kinds of loans required.

Conversely, others within the banking industry view the fence not as restraining outside competitors but as restraining the geographic scope of their own activities. Those desiring to expand their playing field view McFadden as a regulatory straitjacket restraining their ability to compete. Those who favor unrestricted branching reject the anti-competitive argument and reason that large interstate banks that are unresponsive to the needs of a local community will not attract customers and, hence, will not be a real competitive force within the market. Consequently, an unresponsive large bank is destined to be unsuccessful. An interstate bank that succeeds by responding to local needs would be creating more competition—not less. These voices would argue that the well managed community bank is in no danger of suffering substantial deposit and loan loss to large interstate banks. An efficiently operated bank that has been serving a community for years and is knowledgeable about its credit needs will easily maintain an adequate customer base.

Those in favor of relaxing geographic restrictions assert that a certain amount of consolidation in the industry is desirable. Banks that are operating inefficiently will come under increased competitive pressure to improve efficiency or leave the industry. Competition is purported to be in the public interest, promoting efficiency and assuring the lowest cost of goods and services to the consumer.

Opinion on interstate banking is as varied as it is abundant. The positions of interest groups whose constituencies would be affected by a move to interstate banking vary, predictably, according to what constituents expect to lose or gain. To pinpoint the key issues, this article

reviews the policy stands of some of the most influential lobbying groups in the financial services industry.

## American Bankers Association

Perhaps the most influential of the bank lobbies is the American Bankers Association. The ABA has about 13,600 banks and trust companies in its membership, accounting for 91 percent of all commercial banks in the United States. The ABA's situation is rather sensitive when it comes to policy because of the composition of its membership. The association serves small and large banks alike. Conflicts are frequent, encouraging compromise.

Although a powerful voice for the banking industry, the ABA has not taken a firm position on interstate banking to date. It has long supported McFadden and Douglas and probably will continue to do so. The ABA came out in favor of

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*“An interstate bank that succeeds by responding to local needs would be creating more competition—not less.”*

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the Regulators Bill, which provided for interstate acquisitions in emergencies. It supported measures which first would exhaust all intrastate possibilities, and then would explore those in contiguous states before going nationwide in search of a purchaser.

The ABA's general position is that deregulation of products and services represents a first step toward an improved banking environment. Relaxation of geographic restrictions may then be indicated.

## Independent Bankers Association of America

The Independent Bankers Association of America is a bank lobby with a less general membership than the ABA. The IBAA's membership consists of about 7,300 small and medium sized banks. One of the IBAA's stated purposes is to oppose concentration of banking credit powers in chains, branch systems, or holding



company combines of banks. As we might expect, this goal has led the IBAA to oppose interstate banking.

In 1980, the IBAA favored legislation to prohibit the takeover of nonbank depository institutions by banks or bank holding companies except when a troubled institution is involved. Failure to limit the power to acquire nonbank institutions would, according to IBAA, result in a potentially uncontrollable consolidation movement. The association also expressed fear that allowing banks to acquire S&Ls would undermine state branching laws, because banks would capitalize on the broad branching powers granted S&Ls and circumvent state laws.

Following the release of the Carter report, "Geographic Restrictions on Commercial Banking in the United States," the IBAA came out against any of the recommended modifications of McFadden and Douglas. Any such changes, the IBAA argued, would lead to a "substantial" increase in banking concentration, giving a vast amount of economic power to fewer and fewer banks. Centralization of decision-making over banking would also increase, interfering with the states' role in managing their own banking affairs. The IBAA supports the role of state banking authorities in supervising the financial system. According to the IBAA, policies geared to local needs can be produced only at the state level.

The IBAA asserts that small banks can survive and profit in a turbulent financial marketplace unless that marketplace is weighted against them. The McFadden Act and the Douglas Amendment, according to the association, represent "fundamental safeguards of the nation's decentralized network of independent unit banks." It is the IBAA's contention that changes in the interstate banking laws would hurt the nation's depository institutions and the small communities served by them.

## Association of Bank Holding Companies

The Association of Bank Holding Companies is comprised of 179 holding companies registered with the Federal Reserve Board under the Bank Holding Company Act of 1956. The position of ABHC on interstate banking is reflected rather concisely in a draft bill referred to as the "Regional Banking Deregulation Act." This proposal would amend the Douglas Amendment to permit a bank holding company to acquire other bank holding companies in contiguous states.

Proponents claim this piece of legislation represents the best solution to the interstate banking question for several reasons:

(1) A gradual approach to interstate banking would allow all banks to develop their banking skills before competing nationwide.

(2) Identifying market areas in terms of state boundaries would provide clearly defined markets.

(3) The contiguous state approach would allow banks to expand within a region having similar financial needs, permitting bankers to do full service business in their "natural" market areas.

Specifically, the bill calls for gradual relaxation of restrictions on bank holding company acquisitions across state lines, subject to certain safeguards.<sup>2</sup> First, mergers would be allowed only between bank holding companies, protecting banks that do not desire holding company affiliation from forced acquiescence. Second, acquisitions would be permitted only into states contiguous to the acquiring company's home state. Moving the head office into another state would be prohibited under the act, eliminating the fear of "leap-frogging" into still other states. Finally, the ABHC bill would limit the number of acquisitions for the first five years. Holding companies over \$500 million in assets would be allowed only one merger per state. Companies smaller than \$500 million, on the other hand, would not be restricted in the number of holding companies they could acquire.

The ABHC argues that this approach would fulfill the objectives of the Carter study on interstate banking, while at the same time protecting the integrity of the dual banking system and guarding against undue concentration of banking credit power. Community bankers would be safe under this plan. By resisting bank holding company affiliation, they would be protected from acquisition by an out-of-state holding company. As far as any new competitive threat is concerned, the community banker would remain safe because *de novo* entry is prohibited under the ABHC proposal. State bank supervisors could also rest easy because the "Regional Banking Deregulation Act" would preserve the state supervisor's regulatory authority. A bank affiliated with a holding company would

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<sup>2</sup>"Special Report Commercial Banking Review: Geographic Expansion," from *United States Banker*, March 1981.



remain a state bank after acquisition by an out-of-state holding company, and would remain subject to laws of the state in which it is located.

## Conference of State Bank Supervisors

The Conference of State Bank Supervisors serves state officials responsible for the supervision of state-chartered banks. The CSBS defines as its goal the maintenance of a strong, decentralized dual banking system and improvement in the efficiency and effectiveness of state banking departments. In the CSBS's view, the McFadden Act and the Douglas Amendment are fundamental safeguards of state-federal checks and balances.

The important issue in the interstate banking debate, according to the CSBS, is not whether banking services may be offered on an interstate basis; interstate banking services are already available. What concerns the CSBS is preemption of a state's authority to determine who may operate within its boundaries and to what extent. Dismantling the present legal framework would jeopardize the state banking department's control in banking matters, the group fears, and result in undue concentration of financial resources. This, in turn, would restrict competition. Michael Edwards, chairman and president of the CSBS, has said that "in the name of progress (the deregulators) would turn the clock back to 1929 and in the process tell us to forget the current structure with its tremendous versatility and flexibility."<sup>3</sup>

The CSBS believes the states—not the federal government—are the vehicles for orderly, effective change. State banking departments work to provide optimum financial services while preserving individual economic freedom, the association argues. Changes in laws protecting the state's role in banking matters ultimately would corrupt the financial system, it says, and result in an excessively concentrated banking industry operating to the detriment of many states. The CSBS asserts that interstate services will expand without changes in current laws and that, therefore, such changes are unwarranted.

## Conclusion

Debate over interstate banking will continue. Whether we have full-scale nationwide branching, regional branching, or we simply continue under the same guidelines will be determined in part by the political strength of opposing interest groups. The power and influence of these groups will be tested. However, the number of opposing viewpoints assures us that every proposal will be thoroughly contested before emerging as a finished piece of legislation. Indeed, the very existence of these groups helps ensure that a compromise acceptable to all parties is achieved. The process of congressional debate—with input from all of these groups—serves the best interest of the banking industry as well as the nation.

—Charles R. Haywood

<sup>3</sup>Since this article was written, both IBAA and CSBS have adopted positions favoring expanded bank and bank holding company powers and development of reciprocal services arrangements, while maintaining their commitments to state determination in banking matters (see **U. S. Banker**, March 1983). Though not an endorsement of the ABHC Bill discussed above, this development does, perhaps, indicate a trend toward agreement on the fundamental issues.

## REFERENCES

Information about the positions of these groups was taken from a variety of sources. The documents consulted are listed below:

### Independent Bankers Association of America

IBAA statement before the Senate Committee on Banking, Housing and Urban Affairs concerning major banking and consumer protection laws, May 6, 1981; Oral statement by Robert McCormick, former president, before the House Subcommittee on Financial Institutions, Regulation, and Insurance regarding the Garn-Regan Bill, September 22, 1982; Remarks by Kenneth Guenther, executive director, before the Independent Bankers Division of the Tennessee Bankers Association, May 11, 1982; Statement of IBAA before the Subcommittee on Monopolies of the House Committee on the Judiciary concerning the structure of the financial services industry, July 8, 1981.

### Association of Bank Holding Companies

"Special Report Commercial Banking Review: Geographic Expansion," from **United States Banker**, March 1981; "Interstate Banking: The Contiguous State Approach," Background Paper-Association of Reserve

City Bankers, July 1981; "Deregulating Interstate Banking: ABHC Cities Strong Support from Members," **American Banker**, March 6, 1981.

### Conference of State Bank Supervisors

"Interview with Lawrence Kreider, executive VP-economist, and Michael Edwards, president, CSBS," **United States Banker**, September 1981; "Interstate Banking: Salvation or Suicide?" **The Supervisor**, November 1980; Press releases of CSBS, 1981-1982.

### American Bankers Association

Testimony of Llewellyn Jenkins on behalf of ABA on S.1720 and S.1721 before the Senate Committee on Banking, Housing and Urban Affairs, October 20, 1981; Testimony of Lee E. Gunderson on behalf of ABA on S.2532 and S.2532 before the Senate Committee on Banking, Housing and Urban Affairs, May 27, 1982.



# Conclusion

A wave of market forces, including the trend toward financial conglomerates, the success of the money market mutual funds, and the crisis in the thrift industry, has increased interest in the question of interstate banking. Should we allow interstate banking? What type of interstate banking should be allowed? Should we change the Douglas Amendment or the McFadden Act? If the prohibitions are removed, how quickly will interstate banking occur and what form will it take? How disruptive is it likely to be moving from a market structure mandated by geographic prohibitions to a structure free of these prohibitions? What are the potential private and public benefits and costs associated with such freedom? This special issue of the Review addressed a number of these questions in an attempt to further understanding of the issues. What, then, may we conclude?

First, we found that the largest bank holding companies have already established a sizable interstate presence through nonbank subsidiaries.

Many of the holding companies are headquartered in the Northeast and have established interstate offices, mainly in high growth and densely populated states. These same states attractive for nonbank entry will prove to be the most attractive areas for interstate banking should the prohibition be lifted.

Given what these large holding companies have already obtained, they appear to have little incentive to establish vast nationwide interstate systems of acquired banks seeking to attract relatively marginal accounts. This will become increasingly true as banks come under competitive pressure to pay market rates for these accounts. Given these factors, interstate banking is likely to proceed slowly and to be concentrated geographically if the prohibitions are removed.

Market forces have propelled us into an interstate financial world. Many financial services are currently available on an interstate basis and new financial services that know no geographic restrictions are being developed almost daily. As has occurred in the past with most major banking legislation, market forces are necessitating legislative change.

Finding the right bridge to an interstate banking system will be complex. A number of advantages are associated with allowing interstate banking through the branching route or through the establishment of banks. And further, there are advantages and disadvantages to be considered in allowing *de novo* expansion or expansion through acquisition. The specific approach to interstate banking must also find a way to deal with interstate financial services that have developed or will develop even without legislative changes.

## Interstate Tide Will Be Slow

Even without legislative mandates, the development of interstate banking systems most likely will be slow. As we have seen, banks enjoy no great cost advantages as they increase in size. Therefore, potential cost savings will not be a driving force behind interstate expansion. Empirical research also indicates no substantial scope economies in banking. These two elements imply that smaller local banks have relatively little to fear from larger interstate competitors in terms of cost disadvantages.

Interstate banking will not spell the end of such local banks. As long as these banks are providing services consumers desire they will remain in the marketplace. They may not be able to offer all the services provided by an interstate system but, as the Canadian experience indicates, there is a good deal of potential for them to remain competitive by offering customized banking services.

On another front, it was shown that the way we regulate bank capital will also tend to slow the development of interstate banking systems. While many community and smaller regional banking organizations have excess capital under current guidelines, the capital positions of larger regional holding companies and the multinationals seem to be weaker. Interstate expansion by the largest banking organizations may be somewhat restrained by capital considerations, but the medium and small sized banks are in a better position to meet the capital guidelines. The smaller organizations, then, not only have a reason to expand interstate but they also have the capacity to do so.

The market's assessment of interstate banking's potential profitability is important because it will affect the cost of raising new equity capital to support interstate expansion. As we have



seen, there is little reason to believe that interstate organizations will be substantially more profitable than noninterstate organizations. Quite the contrary, nationwide brick-and-mortar facilities established to collect marginal accounts at money market rates may in fact reduce profits, limiting an organization's ability to expand.

The form and pace of interstate banking also will be influenced by technological considerations. It was shown that the elements of an interstate retail electronic banking system are already in place. However, even on this front the hazy legal status of shared nationwide systems and apparent consumer reluctance will slow its development.

The Canadian experience demonstrates that interstate branching may assist in movement of funds and convenient access to funds and standardized financial services for large customer groups. Something may be lost, however, in terms of an interstate system's ability to respond or relate to small localized consumers. The Canadian example is instructive, but the interstate system that develops in this country will not mirror the Canadian system. We have already developed many relatively small institutions; there is little compelling reason to believe they will disappear.

Another certainty is that banking lobby groups will ensure that all aspects of the interstate question receive serious review by legislators. This is as it should be. A sound and competitively viable banking industry will be ensured only if all aspects of the issue receive adequate review.

A wave of market pressures will force legislative review of the interstate banking issue. These include the phaseout of Regulation Q, introduction of mandatory reserve requirements on all financial institutions holding transaction balances, the ability of banks and thrifts to offer new accounts paying money market rates, states individually passing reciprocal agreements to allow entry by out-of-state banking organizations, and the perceived increase in competitive pressures from nonbanks. Another wave of developments favorable to interstate banking involves troubled institutions. This wave includes the Board of Governors' decision to allow bank holding companies to acquire S&Ls across state lines, the Federal Home Loan Bank Board's decision to allow S&Ls to acquire troubled associations across state lines, and the Garn-St Germain Act's emergency provisions

allowing interstate acquisition of troubled thrifts and banks.

## Shaping A New Structure

Some form of interstate banking is inevitable; in fact, it is occurring today as states individually pass reciprocal agreements. The major issue no longer revolves around the question of whether or not to move to interstate banking; the major issue is how to move to a banking structure freed of geographic constraints.

A major concern of legislators will be the market consequences of removing interstate prohibitions. Will removal of the prohibitions substantially increase the concentration of financial resources. The net effect of this increase, however, is likely to be marginal.

As we have seen, even though current antitrust laws would do little to prohibit market extension mergers, the largest banking organizations will face both regulatory and market imposed constraints on their ability to expand their interstate presence. Removing interstate prohibitions would result in a rather slow evolution toward a new market structure. This slow evolution will help ensure that a number of interstate organizations will develop not only from the ranks of the money center organizations but also from the ranks of medium and large regionals that have both the capacity and desire to expand interstate.

At the same time, no compelling reason was uncovered to suggest that small banks would be at a competitive disadvantage in local markets. From the standpoint of concentration of financial resources or maintenance of competitive markets, there appears to be little to fear from removal of the interstate prohibition.

Should we remove the McFadden or Douglas prohibitions, or perhaps both? Our research found no serious or substantial economic reasons to prefer removing one over the other. Establishing an interstate system of banks, however, would result in fewer regulatory changes both at the state and federal level and would not upset our dual banking system to the extent a branching network would. Therefore, changes in the Douglas Amendment to allow interstate banking would seem to be the path of least resistance.





# FINANCE

# STATISTICAL SUPPLEMENT

	MAR 1983	FEB 1983	MAR 1982	ANN. % CHG.		MAR 1983	FEB 1983	MAR 1982	ANN. % CHG.
<b>\$ millions</b>									
<b>UNITED STATES</b>									
Commercial Bank Deposits	1,240,595	1,232,245	1,107,194	+ 12	Savings & Loans				
Demand	291,502	291,797	286,559	+ 2	Total Deposits	579,479	570,029	524,289	+ 11
NOW	72,783	69,797	54,553	+ 33	NOW	16,145	15,351	8,666	+ 86
Savings	304,296	277,655	148,043	+106	Savings	174,981	156,897	91,807	+ 91
Time	603,376	622,246	647,252	- 7	Time	391,346	400,379	424,393	- 8
Credit Union Deposits	53,467	52,089	43,101	+ 24	<b>JAN</b>	<b>472,795</b>	<b>473,656</b>	<b>508,349</b>	- 7
Share Drafts	4,582	4,312	2,772	+ 65	<b>DEC</b>	<b>18,859</b>	<b>17,964</b>	<b>15,073</b>	+ 25
Savings & Time	43,467	42,746	37,668	+ 15	<b>JAN</b>				
					Mortgages Outstanding	472,795	473,656	508,349	- 7
					Mortgage Commitments	18,859	17,964	15,073	+ 25
<b>SOUTHEAST</b>									
Commercial Bank Deposits	138,482	136,837	119,831	+ 16	Savings & Loans				
Demand	34,463	34,088	34,318	+ 0	Total Deposits	84,096	82,694	77,150	+ 9
NOW	9,677	9,355	7,169	+ 35	NOW	2,772	2,634	1,424	+ 95
Savings	33,311	30,115	14,711	+126	Savings	22,614	19,850	11,707	+ 93
Time	64,197	66,009	67,072	- 4	Time	59,453	60,813	64,037	- 7
Credit Union Deposits	5,056	4,979	4,225	+ 20	<b>JAN</b>	<b>66,177</b>	<b>66,984</b>	<b>75,574</b>	- 12
Share Drafts	370	363	289	+ 28	<b>DEC</b>	<b>3,165</b>	<b>2,979</b>	<b>3,340</b>	- 5
Savings & Time	4,304	4,248	3,621	+ 19	<b>JAN</b>				
					Mortgages Outstanding	66,177	66,984	75,574	- 12
					Mortgage Commitments	3,165	2,979	3,340	- 5
<b>ALABAMA</b>									
Commercial Bank Deposits	14,740	14,571	13,511	+ 9	Savings & Loans				
Demand	3,516	3,527	3,420	+ 3	Total Deposits	4,592	4,564	4,412	+ 4
NOW	875	836	622	+ 41	NOW	202	178	74	+173
Savings	2,816	2,583	1,523	+ 85	Savings	690	649	571	+ 21
Time	7,986	8,032	8,389	- 5	Time	3,768	3,784	3,791	- 1
Credit Union Deposits	855	852	734	+ 16	<b>JAN</b>	<b>3,625</b>	<b>3,685</b>	<b>3,979</b>	- 9
Share Drafts	71	69	56	+ 27	<b>DEC</b>	<b>76</b>	<b>47</b>	<b>49</b>	+ 55
Savings & Time	729	723	625	+ 17	<b>JAN</b>				
					Mortgages Outstanding	3,625	3,685	3,979	- 9
					Mortgage Commitments	76	47	49	+ 55
<b>FLORIDA</b>									
Commercial Bank Deposits	47,790	46,681	39,637	+ 21	Savings & Loans				
Demand	12,490	12,127	12,362	+ 1	Total Deposits	51,050	50,188	46,917	+ 9
NOW	4,116	4,012	3,164	+ 30	NOW	1,881	1,787	998	+ 88
Savings	14,943	13,438	6,352	+135	Savings	15,407	13,503	7,868	+ 96
Time	17,189	17,924	18,681	- 8	Time	34,156	35,181	37,958	- 10
Credit Union Deposits	2,285	2,247	1,925	+ 19	<b>JAN</b>	<b>38,710</b>	<b>39,268</b>	<b>46,672</b>	- 17
Share Drafts	198	193	162	+ 22	<b>DEC</b>	<b>2,394</b>	<b>2,346</b>	<b>2,906</b>	- 18
Savings & Time	1,804	1,787	1,523	+ 18	<b>JAN</b>				
					Mortgages Outstanding	38,710	39,268	46,672	- 17
					Mortgage Commitments	2,394	2,346	2,906	- 18
<b>GEORGIA</b>									
Commercial Bank Deposits	19,569	19,532	16,352	+ 20	Savings & Loans				
Demand	6,179	6,184	5,837	+ 6	Total Deposits	10,416	10,256	9,657	+ 8
NOW	1,275	1,251	1,010	+ 26	NOW	268	250	146	+ 84
Savings	4,303	4,097	1,578	+173	Savings	2,373	2,158	1,166	+104
Time	8,714	8,840	8,893	- 2	Time	7,928	8,018	8,380	- 5
Credit Union Deposits	959	934	778	+ 23	<b>JAN</b>	<b>8,481</b>	<b>8,641</b>	<b>9,333</b>	- 9
Share Drafts	37	39	25	+ 48	<b>DEC</b>	<b>286</b>	<b>190</b>	<b>124</b>	+131
Savings & Time	862	836	720	+ 20	<b>JAN</b>				
					Mortgages Outstanding	8,481	8,641	9,333	- 9
					Mortgage Commitments	286	190	124	+131
<b>LOUISIANA</b>									
Commercial Bank Deposits	24,190	24,114	21,605	+ 12	Savings & Loans				
Demand	5,843	5,874	6,194	- 6	Total Deposits	8,655	8,430	7,577	+ 14
NOW	1,294	1,240	977	+ 32	NOW	179	172	88	+103
Savings	4,477	4,094	2,394	+ 87	Savings	2,148	1,841	1,208	+ 78
Time	13,077	13,322	12,716	+ 3	Time	6,402	6,470	6,298	+ 2
Credit Union Deposits	163	162	115	+ 42	<b>JAN</b>	<b>7,338</b>	<b>7,394</b>	<b>7,180</b>	+ 2
Share Drafts	13	12	9	+ 44	<b>DEC</b>	<b>234</b>	<b>210</b>	<b>207</b>	+ 13
Savings & Time	154	153	107	+ 44	<b>JAN</b>				
					Mortgages Outstanding	7,338	7,394	7,180	+ 2
					Mortgage Commitments	234	210	207	+ 13
<b>MISSISSIPPI</b>									
Commercial Bank Deposits	11,144	11,034	10,002	+ 11	Savings & Loans				
Demand	2,327	2,346	2,362	- 1	Total Deposits	2,525	2,508	2,382	+ 6
NOW	750	715	536	+ 40	NOW	69	86	40	+ 72
Savings	2,026	1,734	734	+176	Savings	485	417	221	+119
Time	6,302	6,473	6,635	- 5	Time	1,999	2,028	2,136	- 6
Credit Union Deposits	N.A.	N.A.	N.A.		<b>JAN</b>	<b>2,028</b>	<b>2,033</b>	<b>2,199</b>	- 8
Share Drafts	N.A.	N.A.	N.A.		<b>DEC</b>	<b>22</b>	<b>21</b>	<b>15</b>	+ 47
Savings & Time	N.A.	N.A.	N.A.		<b>JAN</b>				
					Mortgages Outstanding	2,028	2,033	2,199	- 8
					Mortgage Commitments	22	21	15	+ 47
<b>TENNESSEE</b>									
Commercial Bank Deposits	21,049	20,905	18,724	+ 12	Savings & Loans				
Demand	4,108	4,030	4,143	- 1	Total Deposits	6,858	6,748	6,205	+ 11
NOW	1,367	1,301	860	+ 59	NOW	173	161	78	+122
Savings	4,746	4,169	2,130	+123	Savings	1,511	1,282	673	+125
Time	10,929	11,418	11,758	- 7	Time	5,200	5,332	5,474	- 5
Credit Union Deposits	794	784	673	+ 18	<b>JAN</b>	<b>5,200</b>	<b>5,332</b>	<b>5,474</b>	- 5
Share Drafts	51	50	37	+ 38	<b>DEC</b>	<b>153</b>	<b>165</b>	<b>39</b>	+292
Savings & Time	755	749	646	+ 17	<b>JAN</b>				
					Mortgages Outstanding	5,995	5,963	6,211	- 3
					Mortgage Commitments	153	165	39	+292

**Notes:** All deposit data are extracted from the Federal Reserve Report of Transaction Accounts, other Deposits and Vault Cash (FR2900), and are reported for the average of the week ending the 1st Wednesday of the month. This data, reported by institutions with over \$15 million in deposits as of December 31, 1979, represents 95% of deposits in the six state area. The major differences between this report and the "call report" are size, the treatment of interbank deposits, and the treatment of float. The data generated from the Report of Transaction Accounts is for banks over \$15 million in deposits as of December 31, 1979. The total deposit data generated from the Report of Transaction Accounts eliminates interbank deposits by reporting the net of deposits "due to" and "due from" other depository institutions. The Report of Transaction Accounts subtracts cash in process of collection from demand deposits, while the report does not. Savings and loan mortgage data are from the Federal Home Loan Bank Board Selected Balance Sheet Data. The Southeast data represent the total of the six states. Subcategories were chosen on a selective basis and do not add to total. A bank fewer than four institutions reporting.





# EMPLOYMENT

	FEB 1983	JAN 1983	FEB 1982	ANN. % CHG.		FEB 1983	JAN 1983	FEB 1982	ANN. % CHG.
<b>UNITED STATES</b>									
Civilian Labor Force - thous.	109,647	109,779	108,324	+ 1	Nonfarm Employment- thous.	87,700	87,719	89,413	- 2
Total Employed - thous.	97,265	97,262	97,946	- 1	Manufacturing	18,067	18,035	19,299	- 6
Total Unemployed - thous.	12,382	12,517	10,378	+19	Construction	3,389	3,536	3,559	- 5
Unemployment Rate - % SA	10.4	10.4	8.8		Trade	20,029	20,285	20,258	- 1
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	15,970	15,727	16,085	- 1
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	19,004	18,872	18,696	+ 2
Mfg. Avg. Wkly. Hours	38.7	39.2	39.2	- 1	Fin., Ins., & Real Est.	5,358	5,352	5,285	+ 1
Mfg. Avg. Wkly. Earn. - \$	339	341	327	+ 4	Trans. Com. & Pub. Util.	4,887	4,899	5,051	- 3
<b>SOUTHEAST</b>									
Civilian Labor Force - thous.	14,045	14,104	13,773	+ 2	Nonfarm Employment- thous.	11,369	11,319	11,375	- 0
Total Employed - thous.	12,467	12,468	12,475	- 0	Manufacturing	2,126	2,126	2,223	- 4
Total Unemployed - thous.	1,455	1,636	1,300	+12	Construction	603	608	646	- 7
Unemployment Rate - % SA	11.0	11.1	9.2		Trade	2,703	2,705	2,651	+ 2
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	2,169	2,141	2,161	+ 0
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	2,282	2,259	2,193	+ 4
Mfg. Avg. Wkly. Hours	39.6	39.7	39.4	+ 1	Fin., Ins., & Real Est.	653	649	641	+ 2
Mfg. Avg. Wkly. Earn. - \$	299	300	285	+ 5	Trans. Com. & Pub. Util.	689	687	698	- 1
<b>ALABAMA</b>									
Civilian Labor Force - thous.	1,736	1,732	1,661	+ 5	Nonfarm Employment- thous.	1,302	1,301	1,316	- 1
Total Employed - thous.	1,457	1,442	1,446	+ 1	Manufacturing	325	325	349	- 7
Total Unemployed - thous.	280	290	214	+31	Construction	58	57	53	+ 9
Unemployment Rate - % SA	15.6	16.3	13.4		Trade	266	267	263	+ 1
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	292	290	291	+ 0
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	219	218	212	+ 3
Mfg. Avg. Wkly. Hours	39.8	39.4	39.4	+ 1	Fin., Ins., & Real Est.	58	59	58	0
Mfg. Avg. Wkly. Earn. - \$	298	295	288	+ 3	Trans. Com. & Pub. Util.	70	70	71	- 1
<b>FLORIDA</b>									
Civilian Labor Force - thous.	4,679	4,783	4,528	+ 3	Nonfarm Employment- thous.	3,859	3,818	3,789	+ 2
Total Employed - thous.	4,235	4,285	4,208	+ 1	Manufacturing	464	463	471	- 1
Total Unemployed - thous.	320	499	322	- 1	Construction	237	237	263	-10
Unemployment Rate - % SA	9.7	10.2	7.3		Trade	1,039	1,031	1,001	+ 4
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	641	630	637	+ 1
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	949	933	899	+ 6
Mfg. Avg. Wkly. Hours	40.0	40.2	39.6	+ 1	Fin., Ins., & Real Est.	285	281	279	+ 2
Mfg. Avg. Wkly. Earn. - \$	291	292	270	+ 8	Trans. Com. & Pub. Util.	234	232	229	+ 2
<b>GEORGIA</b>									
Civilian Labor Force - thous.	2,649	2,624	2,604	+ 2	Nonfarm Employment- thous.	2,198	2,196	2,170	+ 1
Total Employed - thous.	2,424	2,406	2,393	+ 1	Manufacturing	493	492	505	- 2
Total Unemployed - thous.	225	217	211	+ 7	Construction	93	97	98	- 5
Unemployment Rate - % SA	8.2	8.3	8.0		Trade	518	519	504	+ 3
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	444	442	435	+ 2
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	380	377	362	+ 5
Mfg. Avg. Wkly. Hours	39.8	39.3	39.1	+ 2	Fin., Ins., & Real Est.	118	118	114	+ 4
Mfg. Avg. Wkly. Earn. - \$	279	272	259	+ 8	Trans. Com. & Pub. Util.	144	144	145	- 1
<b>LOUISIANA</b>									
Civilian Labor Force - thous.	1,820	1,820	1,840	- 1	Nonfarm Employment- thous.	1,588	1,585	1,623	- 2
Total Employed - thous.	1,609	1,606	1,660	- 3	Manufacturing	193	195	214	-10
Total Unemployed - thous.	211	214	181	+17	Construction	117	117	126	- 7
Unemployment Rate - % SA	11.3	10.9	9.4		Trade	364	366	363	+ 0
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	311	306	309	+ 1
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	305	304	299	+ 2
Mfg. Avg. Wkly. Hours	39.3	40.8	40.5	- 3	Fin., Ins., & Real Est.	80	79	78	+ 3
Mfg. Avg. Wkly. Earn. - \$	377	390	373	+ 1	Trans. Com. & Pub. Util.	125	125	131	- 5
<b>MISSISSIPPI</b>									
Civilian Labor Force - thous.	1,043	1,032	1,038	+ 0	Nonfarm Employment- thous.	780	780	793	- 2
Total Employed - thous.	913	906	925	- 1	Manufacturing	195	196	206	- 5
Total Unemployed - thous.	130	126	113	+15	Construction	39	39	39	0
Unemployment Rate - % SA	11.7	11.5	9.6		Trade	159	160	157	+ 1
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	182	180	184	- 1
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	123	123	121	+ 2
Mfg. Avg. Wkly. Hours	39.0	39.0	38.8	+ 1	Fin., Ins., & Real Est.	33	33	33	0
Mfg. Avg. Wkly. Earn. - \$	257	257	247	+ 4	Trans. Com. & Pub. Util.	38	39	39	- 3
<b>TENNESSEE</b>									
Civilian Labor Force - thous.	2,118	2,113	2,102	+ 1	Nonfarm Employment- thous.	1,642	1,639	1,684	- 2
Total Employed - thous.	1,829	1,823	1,843	- 1	Manufacturing	456	455	478	- 5
Total Unemployed - thous.	289	290	259	+12	Construction	59	61	67	-12
Unemployment Rate - % SA	12.8	12.4	11.4		Trade	357	362	363	- 2
Insured Unemployment - thous.	N.A.	N.A.	N.A.		Government	299	293	305	- 2
Insured Unempl. Rate - %	N.A.	N.A.	N.A.		Services	306	304	300	+ 2
Mfg. Avg. Wkly. Hours	39.8	39.7	39.2	+ 2	Fin., Ins., & Real Est.	79	79	79	0
Mfg. Avg. Wkly. Earn. - \$	295	293	276	+ 7	Trans. Com. & Pub. Util.	78	77	83	- 6

Notes: All labor force data are from Bureau of Labor Statistics reports supplied by state agencies. Only the unemployment rate data are seasonally adjusted. The Southeast data represent the total of the six states. The annual percent change calculation is based on the most recent data over prior year.





# CONSTRUCTION

	FEB 1983	JAN 1983	FEB 1982	ANN % CHG		FEB 1983	JAN 1983	FEB 1982	ANN % CHG
<b>12-month Cumulative Rate</b>									
<b>UNITED STATES</b>									
Nonresidential Building Permits - \$ Mil.					Residential Building Permits				
Total Nonresidential	44,869	45,193	51,662	- 13	Value - \$ Mil.	42,812	41,118	38,554	+ 11
Industrial Bldgs.	4,999	4,967	7,042	- 29	Residential Permits - Thous.				
Offices	11,867	11,924	14,929	- 21	Single-family units	584.3	561.1	528.5	+ 11
Stores	5,228	5,241	6,163	- 15	Multi-family units	480.3	460.8	395.7	+ 21
Hospitals	1,580	1,746	1,674	- 6	Total Building Permits				
Schools	781	785	796	- 2	Value - \$ Mil.	87,681	86,312	90,216	- 3
<b>SOUTHEAST</b>									
Nonresidential Building Permits - \$ Mil.					Residential Building Permits				
Total Nonresidential	6,487	6,526	6,626	- 2	Value - \$ Mil.	7,529	7,282	7,700	- 2
Industrial Bldgs.	677	727	798	- 15	Residential Permits - Thous.				
Offices	1,430	1,405	1,356	+ 5	Single-family units	121.6	116.6	109.6	+ 11
Stores	968	947	1,070	- 10	Multi-family units	91.1	87.8	94.2	- 3
Hospitals	345	341	288	+ 20	Total Building Permits				
Schools	105	108	82	+ 28	Value - \$ Mil.	14,016	13,809	14,326	- 2
<b>ALABAMA</b>									
Nonresidential Building Permits - \$ Mil.					Residential Building Permits				
Total Nonresidential	371	394	434	- 15	Value - \$ Mil.	260	248	273	- 5
Industrial Bldgs.	46	62	75	- 39	Residential Permits - Thous.				
Offices	72	73	55	+ 31	Single-family units	5.5	5.2	4.9	+ 12
Stores	61	64	55	+ 11	Multi-family units	4.3	4.2	5.1	- 16
Hospitals	30	36	37	- 19	Total Building Permits				
Schools	5	5	6	- 17	Value - \$ Mil.	631	642	707	- 11
<b>FLORIDA</b>									
Nonresidential Building Permits - \$ Mil.					Residential Building Permits				
Total Nonresidential	3,307	3,296	3,334	- 1	Value - \$ Mil.	4,350	4,223	5,293	- 18
Industrial Bldgs.	380	388	367	+ 4	Residential Permits - Thous.				
Offices	708	687	572	+ 24	Single-family units	62.6	59.8	64.7	- 3
Stores	519	509	617	- 16	Multi-family units	53.0	50.8	66.9	- 21
Hospitals	178	176	150	+ 19	Total Building Permits				
Schools	21	21	20	+ 5	Value - \$ Mil.	7,658	7,518	8,628	- 11
<b>GEORGIA</b>									
Nonresidential Building Permits - \$ Mil.					Residential Building Permits				
Total Nonresidential	980	989	1,065	- 8	Value - \$ Mil.	1,500	1,440	1,025	+ 46
Industrial Bldgs.	134	138	190	- 29	Residential Permits - Thous.				
Offices	227	227	258	- 12	Single-family units	29.0	27.8	20.2	+ 44
Stores	84	85	121	- 31	Multi-family units	14.9	14.4	8.5	+ 75
Hospitals	25	25	34	- 26	Total Building Permits				
Schools	13	15	30	- 57	Value - \$ Mil.	2,480	2,429	2,089	+ 19
<b>LOUISIANA</b>									
Nonresidential Building Permits - \$ Mil.					Residential Building Permits				
Total Nonresidential	1,066	1,030	903	+ 18	Value - \$ Mil.	708	686	582	+ 22
Industrial Bldgs.	63	83	91	- 31	Residential Permits - Thous.				
Offices	310	308	304	+ 2	Single-family units	12.0	11.8	9.7	+ 24
Stores	165	155	128	+ 29	Multi-family units	9.5	9.0	7.5	+ 27
Hospitals	62	54	42	+ 48	Total Building Permits				
Schools	52	51	19	+174	Value - \$ Mil.	1,774	1,716	1,485	+ 19
<b>MISSISSIPPI</b>									
Nonresidential Building Permits - \$ Mil.					Residential Building Permits				
Total Nonresidential	161	163	175	- 8	Value - \$ Mil.	193	191	146	+ 32
Industrial Bldgs.	13	14	18	- 28	Residential Permits - Thous.				
Offices	14	15	44	- 68	Single-family units	3.8	3.7	3.1	+ 23
Stores	39	39	34	+ 15	Multi-family units	2.2	2.2	1.7	+ 29
Hospitals	5	5	6	- 17	Total Building Permits				
Schools	5	5	1	+400	Value - \$ Mil.	354	353	321	+ 10
<b>TENNESSEE</b>									
Nonresidential Building Permits - \$ Mil.					Residential Building Permits				
Total Nonresidential	601	656	715	- 16	Value - \$ Mil.	517	495	381	+ 36
Industrial Bldgs.	41	41	57	- 28	Residential Permits - Thous.				
Offices	100	95	123	- 19	Single-family units	8.6	8.2	6.8	+ 26
Stores	100	95	116	- 14	Multi-family units	7.2	7.2	4.5	+ 60
Hospitals	44	44	19	+132	Total Building Permits				
Schools	9	11	6	+ 50	Value - \$ Mil.	1,118	1,151	1,096	+ 2

## NOTES:

Data supplied by the U. S. Bureau of the Census, Housing Units Authorized By Building Permits and Public Contracts, C- 40. Nonresidential data excludes the cost of construction for publicly owned buildings. The southeast data represent the total of the six states. The annual percent change calculation is based on the most recent month over prior year. Publication of F. W. Dodge construction contracts has been discontinued.





# GENERAL

	LATEST DATA	CURR. PERIOD	PREV. PERIOD	YEAR AGO	ANN. % CHG.		MAR 1983	FEB (R) 1983	MAR 1982	ANN. % CHG.
<b>UNITED STATES</b>										
<b>Personal Income</b>						<b>Agriculture</b>				
(\$bil. - SAAR)	3Q	2,584.9	2,541.5	2,447.6	+ 6	Prices Rec'd by Farmers				
Taxable Sales - \$bil.		N.A.	N.A.	N.A.		Index (1977=100)	133	132	133	0
Plane Pass. Arr. 000's		N.A.	N.A.	N.A.		Broiler Placements (thous.)	84,834	81,638	82,723	+ 3
Petroleum Prod. (thous.)	MAR	8,729.1	8,654.1	8,687.8	+ 0	Calf Prices (\$ per cwt.)	68.70	66.50	62.10	+11
Consumer Price Index						Broiler Prices (¢ per lb.)	25.4	27.7	26.9	- 6
1967=100	MAR	293.4	293.2	283.1	+ 4	Soybean Prices (\$ per bu.)	5.63	5.66	5.88	- 4
Kilowatt Hours - mils.	NOV	160.5	163.4	162.1	- 1	Broiler Feed Cost (\$ per ton)	210	206	207	+ 1
<b>SOUTHEAST</b>										
<b>Personal Income</b>						<b>Agriculture</b>				
(\$bil. - SAAR)	3Q	307.4	301.8	289.3	+ 6	Prices Rec'd by Farmers				
Taxable Sales - \$ bil.		N.A.	N.A.	N.A.		Index (1977=100)	119	120	117	+ 2
Plane Pass. Arr. 000's	JAN	4,354.9	3,763.6	3,901.1	+12	Broiler Placements (thous.)	32,526	31,405	31,463	+ 3
Petroleum Prod. (thous.)	MAR	1,400.0	1,397.0	1,392.9	+ 0	Calf Prices (\$ per cwt.)	67.59	63.25	58.80	+15
Consumer Price Index						Broiler Prices (¢ per lb.)	24.8	26.9	26.0	- 5
1967=100		N.A.	N.A.	N.A.		Soybean Prices (\$ per bu.)	5.75	5.79	6.20	- 7
Kilowatt Hours - mils.	NOV	25.0	27.6	24.9	+ 0	Broiler Feed Cost (\$ per ton)	200	195	205	- 2
<b>ALABAMA</b>										
<b>Personal Income</b>						<b>Agriculture</b>				
(\$bil. - SAAR)	3Q	33.8	33.6	32.8	+ 3	Farm Cash Receipts - \$ mil.				
Taxable Sales - \$ bil.	DEC	23.8	23.0	22.4	+ 6	(Dates: JAN, JAN)	158	-	158	0
Plane Pass. Arr. 000's	JAN	93.7	98.0	94.3	- 1	Broiler Placements (thous.)	10,718	10,341	10,497	+ 2
Petroleum Prod. (thous.)	MAR	56.0	54.0	55.4	+ 1	Calf Prices (\$ per cwt.)	66.80	62.50	57.60	+16
Consumer Price Index						Broiler Prices (¢ per lb.)	24.0	27.0	25.0	- 4
1967=100		N.A.	N.A.	N.A.		Soybean Prices (\$ per bu.)	5.69	5.71	6.12	- 7
Kilowatt Hours - mils.	NOV	3.4	3.6	3.5	- 3	Broiler Feed Cost (\$ per ton)	215	210	225	- 4
<b>FLORIDA</b>										
<b>Personal Income</b>						<b>Agriculture</b>				
(\$bil. - SAAR)	3Q	114.3	111.3	105.5	+ 8	Farm Cash Receipts - \$ mil.				
Taxable Sales - \$ bil.	MAR	67.9	67.7	67.2	+ 1	(Dates: JAN, JAN)	524	-	538	- 3
Plane Pass. Arr. 000's	JAN	2,369.1	2,253.8	1,999.3	+18	Broiler Placements (thous.)	1,983	1,965	1,979	+ 0
Petroleum Prod. (thous.)	MAR	65.0	65.0	80.5	-20	Calf Prices (\$ per cwt.)	71.30	65.60	61.20	+17
Consumer Price Index - Miami						Broiler Prices (¢ per lb.)	24.0	27.0	26.0	- 8
Nov. 1977 = 100	MAR	159.0	157.9	155.1	+ 3	Soybean Prices (\$ per bu.)	5.69	5.71	6.12	- 7
Kilowatt Hours - mils.	NOV	6.8	8.1	6.9	- 1	Broiler Feed Cost (\$ per ton)	215	215	225	- 4
<b>GEORGIA</b>										
<b>Personal Income</b>						<b>Agriculture</b>				
(\$bil. - SAAR)	3Q	53.3	52.5	50.6	+ 5	Farm Cash Receipts - \$ mil.				
Taxable Sales - \$ bil.	4Q	40.2	39.4	39.1	+ 3	(Dates: JAN, JAN)	224	-	205	+ 9
Plane Pass. Arr. 000's	JAN	1,474.2	1,568.9	1,406.1	+ 5	Broiler Placements (thous.)	13,223	12,727	12,546	+ 5
Petroleum Prod. (thous.)		N.A.	N.A.	N.A.		Calf Prices (\$ per cwt.)	63.70	59.10	56.10	+14
Consumer Price Index - Atlanta						Broiler Prices (¢ per lb.)	24.5	26.5	25.6	- 4
1967 = 100	FEB	295.1	296.1	279.8	+ 5	Soybean Prices (\$ per bu.)	5.51	5.74	6.07	- 9
Kilowatt Hours - mils.	NOV	3.8	4.2	3.7	+ 3	Broiler Feed Cost (\$ per ton)	250	255	250	0
<b>LOUISIANA</b>										
<b>Personal Income</b>						<b>Agriculture</b>				
(\$bil. - SAAR)	3Q	44.4	43.7	41.8	+ 6	Farm Cash Receipts - \$ mil.				
Taxable Sales - \$ bil.		N.A.	N.A.	N.A.		(Dates: JAN, JAN)	204	-	219	- 7
Plane Pass. Arr. 000's	JAN	262.6	247.7	248.5	+ 6	Broiler Placements (thous.)	N.A.	N.A.	N.A.	
Petroleum Prod. (thous.)	MAR	1,191.0	1,190.0	1,163.0	+ 2	Calf Prices (\$ per cwt.)	66.00	63.30	60.10	+10
Consumer Price Index						Broiler Prices (¢ per lb.)	26.0	28.0	27.5	- 5
1967 = 100		N.A.	N.A.	N.A.		Soybean Prices (\$ per bu.)	5.81	5.87	6.34	- 8
Kilowatt Hours - mils.	NOV	4.3	5.0	4.1	+ 5	Broiler Feed Cost (\$ per ton)	250	255	250	0
<b>MISSISSIPPI</b>										
<b>Personal Income</b>						<b>Agriculture</b>				
(\$bil. - SAAR)	3Q	19.9	19.7	19.0	+ 5	Farm Cash Receipts - \$ mil.				
Taxable Sales - \$ bil.	N.A.	N.A.	N.A.			(Dates: JAN, JAN)	280	-	216	+30
Plane Pass. Arr. 000's	JAN	28.9	29.0	27.9	+ 4	Broiler Placements (thous.)	6,603	6,371	6,441	+ 3
Petroleum Prod. (thous.)	MAR	88.0	88.0	94.0	- 7	Calf Prices (\$ per cwt.)	68.20	64.70	61.20	+11
Consumer Price Index						Broiler Prices (¢ per lb.)	26.5	27.0	28.0	- 5
1967 = 100		N.A.	N.A.	N.A.		Soybean Prices (\$ per bu.)	5.74	5.79	6.20	- 7
Kilowatt Hours - mils.	NOV	1.7	1.1	1.6	+ 6	Broiler Feed Cost (\$ per ton)	169	170	195	-13
<b>TENNESSEE</b>										
<b>Personal Income</b>						<b>Agriculture</b>				
(\$bil. - SAAR)	3Q	41.7	41.0	39.6	+ 5	Farm Cash Receipts - \$ mil.				
Taxable Sales - \$ bil.	JAN	29.2	28.7	27.5	+ 6	(Dates: JAN, JAN)	192	-	166	+16
Plane Pass. Arr. 000's	JAN	126.3	128.8	124.9	+ 1	Broiler Placements (thous.)	N.A.	N.A.	N.A.	
Petroleum Prod. (thous.)	FEB	N.A.	N.A.	N.A.		Calf Prices (\$ per cwt.)	67.90	63.20	56.40	+20
Consumer Price Index						Broiler Prices (¢ per lb.)	24.0	26.5	24.5	- 2
1967 = 100		N.A.	N.A.	N.A.		Soybean Prices (\$ per bu.)	5.89	5.79	6.18	- 5
Kilowatt Hours - mils.	NOV	5.0	4.9	5.1	- 2	Broiler Feed Cost (\$ per ton)	191	184	210	- 9

Notes:  
 Personal Income data supplied by U. S. Department of Commerce. Taxable Sales are reported as a 12-month cumulative total. Plane Passenger Arrivals are collected from 26 airports. Petroleum Production data supplied by U. S. Bureau of Mines. Consumer Price Index data supplied by Bureau of Labor Statistics. Agriculture data supplied by U. S. Department of Agriculture. Farm Cash Receipts data are reported as cumulative for the calendar year through the month shown. Broiler placements are an average weekly rate. The Southeast data represent the total of the six states. N.A. = not available. The annual percent change calculation is based on most recent data over prior year. R = revised.



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