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economic commentary

Regional Interstate Banking

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More and more, bankers and legislators are initiating state laws to lower legal barriers to interstate banking. Using the authority of the Douglas Amendment of the Bank Holding Company Act of 1956, states are opting for one of three kinds of entry for out-of-state bank holding companies to acquire banks within a state's borders:[1]

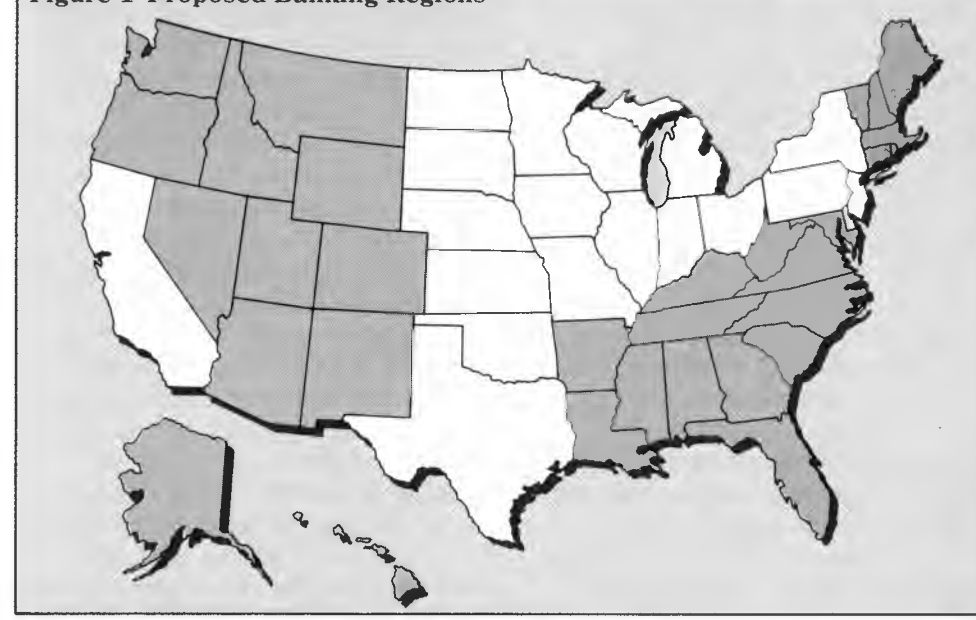
☐ *Unrestricted entry.* Any out-of-state bank holding company can own a bank in the state.

☐ *Reciprocal entry.* An out-of-state bank holding company can own a bank in the state only if the bank holding company's home state permits reciprocal entry.

☐ *Regional reciprocal entry.* An out-of-state bank holding company can own a bank in a state only if the bank holding company is from a reciprocating state in a specified geographic area.

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

Figure 1 Proposed Banking Regions



State Initiatives

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

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The views stated herein are those of the authors and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

1. For a review of legal restrictions on interstate banking and a discussion of the implications of removing these restrictions, see Thomas M. Buynak, Gerald H. Anderson, and James J. Balazsy, Jr., "Banking without Interstate Barriers," *Economic Commentary,* Federal Reserve Bank of Cleveland, March 12, 1984.

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

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

Conclusion

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

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entry. Some form of interstate banking has also been pushed this year in nine other states—Illinois, Iowa, Maryland, Michigan, Minnesota, Missouri, New Jersey, New Mexico, and Wisconsin.

The Effects of Regional Interstate Banking

Regional banking arrangements could provide a transition from regulated, single-state banking to a competitive, nationwide banking environment. According to proponents of regional banking, such pacts would give banks within a specific region time to grow, increasing their ability to resist unfriendly takeovers and to compete with larger banks in a nationwide banking system. Proposed regions typically exclude New York, California, and Illinois—states that house the nation's largest banks, i.e., those with deposits over $15 billion. Banks within a region would benefit from a regional setup if they were planning to acquire interstate banking subsidiaries, because out-of-region banks, especially the aggressive money-center banks, would be excluded from bidding. However, if a bank within a region intended to be acquired, bank stockholders would forego the opportunity to receive more attractive bids from out-of-region banks.

A regional structure does not serve the interests of out-of-region banks. A banking organization that has Edge Act offices, loan production offices, and bank holding company nonbanking subsidiaries in a number of states would be less adversely affected by exclusion from regional zones. Citicorp, for example, currently operates 276 offices in 37 states.[2] However, regional banking would have a larger discriminatory effect on banking organizations that are excluded from regional bank zones and that have few interstate offices.

Regional arrangements might encourage excluded bank holding companies to channel a large percentage of their resources into nonbanking activities. This expansion would enable bank holding companies to establish a presence in states from which they may have been excluded. However, diminishing the importance of a bank relative to its nonbanking affiliates and expanding into less-regulated, nonbanking activities might make the bank holding company more susceptible to financial problems.

How would a bank's customers—large corporations, middle-market companies, small businesses, and consumers—be affected if a state opted for a regional reciprocal arrangement?[3] Because banks already compete for the banking business of large corporations on a nationwide basis, no one interstate banking arrangement would significantly expand the array of banking products or services currently available to large corporations. However, direct access through local affiliated banks might streamline these services. Middle-market companies and small businesses tend to rely on banking services from geographically smaller banking markets.[4] Regardless of how a state lowers its interstate barriers, banking services for middle-market firms and small businesses probably would improve.[5] A regional arrangement might offer more competitive advantages to middle-market firms and small businesses than an unrestricted reciprocal or non-reciprocal arrangement. Proponents of regionalism argue that regional banking organizations would be more responsive to middle-market firms, small businesses, municipalities, and regional industries. Regional banks would already have developed expertise in lending to the region's industries and would be more likely to compete aggressively for the business of middle-market and small firms in the region. Out-of-region banks might find serving these customers more difficult and costly; money-center banks would probably rather attract new business from large corporations and strengthen ties with local corporate customers. Exclusion of the money-center banks from a region would not reduce the banking services available to small- and middle-market firms, since they do not currently offer a significantly wider array of financial products or services to this class of bank customers.

Consumers rely on local banks for the majority of banking services, although technological advances, banking deregulation, and competition from nonbanking firms, such as Sears or Merrill Lynch, are eroding this dependence. Where local-market banking services are still limited and less competitive, lifting geographic banking barriers would have some pro-competitive effects. However, there is no reason to expect that regional banking would improve consumer services any more than unrestricted banking would. One disadvantage of state-initiated regional banking zones is that they could divide many natural banking markets.[6] To illustrate, of the 282 standard metropolitan statistical areas in the United States, 26 extend across state lines. One major advantage of state-legislated interstate banking is that it allows states to shape their own intrastate banking structure and to determine the pace at which it changes.

Choosing Partners

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

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

☐ *Economic structure.* A regional interstate banking pact among states with similar industrial structures would enable banks to make use of their lending expertise and immediately improve competition in the wider area. Alternatively, a banking region that consists of states with contrasting economies would give banks the opportunity to develop more diversified loan portfolios and deposit bases.

☐ *Intrastate banking.* State banking laws determine whether a state allows multibank holding companies and influence a state's banking structure—i.e., the size and number of banks in the state. If the banking structures of member states differ, an interstate banking zone may not be truly reciprocal. States with restrictive branching laws offer fewer opportunities for bank holding companies to expand than states that allow liberal branching.

☐ *Probability of interstate banking legislation.* A state's current branching law may provide a clue to its attitude about authorizing interstate banking. Of the 20 states that allow some sort of interstate banking, 15 have statewide branching, 4 have limited branching, and 1 has unit banking. States with statewide branching seem to be better prospects for regional pacts than states with unit banking.

Legal Issues

Some critics contend that regional banking pacts violate provisions of the U.S. Constitution, one of which specifies that no state shall, without the consent of Congress, enter into any agreement or compact with another state. In April 1984, a federal appeals court stayed two interstate mergers of Massachusetts and Connecticut banking organizations to study the issue of constitutionality. The Federal Reserve Board had approved the mergers, concluding that it would not "hold a state statute to be unconstitutional without clear and unequivocal evidence of the inconsistency of the state law with the U.S. Constitution."[7]

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

Other pending interstate banking legislation includes U.S. Representative Barnard's H.R.5446, which would require federal regulators of banks and savings and loan associations to recognize any state law permitting out-of-state financial institutions to enter that state. In addition, Senator Alfonse D'Amato of New York proposed in S.2107 to phase out the Douglas Amendment over a five-year period, authorizing bank holding companies to acquire one additional bank in each of two states every year for five years. This bill stipulates that if a state forbids entry by out-of-state bank holding companies, its own bank holding companies may not enter other states. D'Amato's bill would remove all interstate restrictions on acquisitions by bank holding companies after the fifth year.

2. See David D. Whitehead, *A Guide to Interstate Banking,* Federal Reserve Bank of Atlanta, 1983.

3. For an analysis of the effects of various routes to interstate banking, see Paul M. Horvitz, "Alternative Avenues to Interstate Banking," *Economic Review,* Federal Reserve Bank of Atlanta, May 1983, pp. 32–9.

4. Evidence indicates small- and medium-sized banks provide most of the dollar volume of bank loans to small businesses. Large banks provide only one-fourth of small business loans, but about two-thirds of total bank loans to large businesses; see Cynthia Glassman and Peter L. Struck, "Survey of Commercial Bank Lending to Small Business," *Studies of Small Business Finance,* Interagency Task Force on Small Business Finance (January 1982), p. 7.

5. See Robert A. Eisenbeis, "The Allocative Effects of Branch Banking Restrictions on Business Loan Markets," *Journal of Bank Research,* vol. 6, no. 1 (Spring 1975), pp. 43–7.

6. See Carter H. Golembe, "Reflections on Regional Interstate Banking," *Banking Expansion Reporter,* vol. 2, no. 24 (December 19, 1983), p. 14.

7. See Federal Reserve Order, March 26, 1984, approving the merger of Bank of New England Corporation, Boston, MA, with CBT Corporation, Hartford, CT, p. 9.