THE FUTURE OF INTERSTATE BANKING

AN ADDRESS BY

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BEFORE
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I. Introduction

Good morning. I am delighted to be back in my old stomping grounds. It is particularly enjoyable to spend some time in Mackinac Island, a place where I helped plan the George Romney for President campaign. George would have made a great President, but he needed better planners.

It is a pleasure to note the fine performance of Michigan banks. Overall, your banks are doing considerably better than their counterparts in surrounding states and throughout the nation. Only four Michigan banks have failed since 1969 and only two since 1974. The percentage of Michigan banks on the problem list is below the national average of eight percent, and the current number is no greater than it was over two years ago. In the meantime, we expect 140 to 160 bank failures this year. Here are some other statistics to be proud of.

	Return on Assets			% of Banks w/earnings losses		
	1980	1984	1985	1980	1984	1985
Michigan Banks	0.72%	0.77%	0.76%	7.47%	10.14%	8.86%
Independent Banks	0.86	0.88	0.94	6.62	7.58	7.81
BHC-affiliated	0.71	0.75	0.74	7.95	11.59	9.44
Neighboring States*	0.79	0.41**	0.71	2.68	7.68	10.21
All U.S. Banks	0.78%	0.62%	0.60%	4.07%	13.82%	16.16%

	Net Chargeoffs as a % of total loans			Equity Capital Ratio		
	1980	1984	1985	1980	1984	1985
Michigan Banks	0.38%	0.48%	0.46%	6.50%	6.23%	6.24%
Independent Banks	0.35	0.42	0.50	7.97	7.91	8.07
BHC-affiliated	0.38	0.49	0.45	6.32	6.02	6.03
Neighboring States*	0.36	1.23**	0.75	6.48	6.63	6.78
All U.S. Banks	0.16%	0.73%	0.82%	5.79%	6.14%	6.21%

*Neighboring States include: Minnesota, Illinois, Indiana, Wisconsin and Ohio.

**1984 results for neighbor states are heavily distorted by Continental Illinois' $1 billion earnings loss. Excluding Continental, Neighboring States' ROA for 1984 was 0.74%.

II. Discussion

Charles Franklin Kettering wrote in Seed for Thought that

> "We should all be concerned about the future because we will have to spend the rest of our lives there."

Interstate banking is in the future for bankers. It will certainly change the industry in many ways yet difficult to predict.

My background in this subject comes from my experience as Chairman of the Governor of Arizona's Commission on Interstate Banking. As a result of the Commission's efforts, the Arizona legislature passed the first nationwide nonreciprocal interstate banking law in the Southwest. It takes effect this October. Arizona bankers recognized that interstate banking was inevitable and chose to get into the vanguard of the movement.

Today, Michigan bankers and bankers throughout the nation already have to take into account competition from across the country as well as across the street. Market forces and modern technology dictate that interstate banking activity will continue to grow. Legal restrictions can slow this trend, but they cannot stop it. It is no longer a question of whether, but when.

Interstate banking activity is adopting a wide variety of forms. Banks are chasing retail customers in more than one state through mail solicitation of deposits, interstate networks of ATMs, and credit cards. They are using Edge Act corporations, loan production offices, call programs, and cash management services to serve commercial customers nationwide. Bank holding companies extend credit, take deposits, and provide trust services through a variety of nonbank subsidiaries. Such subsidiaries include commercial financial and leasing companies, consumer finance companies, mortgage companies, industrial banks, and nonbank trust companies.

"Nonbank banks," which either accept demand deposits or make commercial loans, but not both, are operating in any state they please. Actually, we might as well drop the prefix "non," now that the courts have ruled that a nonbank bank can both offer NOW accounts and make commercial loans. Nonbank bank parents such as E.F. Hutton, Merrill Lynch, and company are looking more like true blue bankers every day.

What does this all add up to? Quite a lot. In 1980, Professor Douglas Ginsburg conservatively estimated that the volume of assets devoted to interstate banking exceeded $120 billion. His figure did not factor in the interstate flow of federal funds and correspondent balances. Today's number undoubtedly would be much higher, given all the interstate bank acquisitions and nonbank bank activity over the past six years.

Banks have expanded interstate for a number of reasons. Meeting competition from other types of financial organizations ranks high on the list. Banks have sought to graze in greener pastures when business conditions declined in their home markets. Others have aimed to diversify their geographic risks by operating in regions with differing economic bases. Interstate activity may also merely reflect a thriving bank's desire to expand and realize scale economies in such services as placing large commercial loans, running trust departments, servicing correspondent banks, and trading federal funds. What's more, interstate operations may increase the total number of transactions over which fixed costs can be amortized.

Underlying the proliferation of interstate operations are reductions in the costs of processing and transmitting information. As computer processing and electronic funds transfers grow cheaper, banks' incremental costs will become increasingly insensitive to distance. When it's almost as cheap to move money across the nation as across town, the incentive to operate in different states and take advantage of different market opportunities becomes strong.

In short, the innovative search for business opportunities, the press of competition, and cost savings flowing from new technologies power the expansion of interstate banking. Market forces are driving this phenomenon. State and federal legal restrictions can affect the pace and the form of interstate activity. But they cannot halt its expansion.

Some have expressed concern that geographic expansion will undermine competition and erode the hometown quality of banking services. While these fears are understandable, recent research suggests that interstate activity will not create an uncompetitive, unresponsive, unsafe industry. Economists Douglas Evanoff and Diana Fortier analyzed claims made about the dangers of geographic expansion in a 1986 issue of the Federal Reserve Bank of Chicago's Economic Perspectives. Let's take a look at what their statistical analysis found.

First, the trend in local market concentration has been downward, not upward. This deconcentration trend has been greatest in markets allowing liberal branching activity.

Second, antitrust law enforcement has been relatively effective in preventing anticompetitive banking behavior.

Third, there is little support for the contention that firms competing in several markets will collude to avoid competition. Indeed, with broader interstate expansion, numerous competitors and geographically dispersed markets should make it harder for banks to collude.

Fourth, lower average returns on assets suggest that competition is keener in more liberal branching markets. Also, evidence does not support the claim that liberalizing geographic expansion will threaten smaller banks' viability. Small banks have thrived in California and New York, two large states with over a decade of statewide banking experience. Indeed, smaller banks have enjoyed higher average returns on assets than larger banks. This result mirrors what happened to A&P, which forty years ago was viewed as certain to eliminate regional independent groceries. Instead, A&P declined and the smaller firms--which did a better job of meeting their customers' needs--prospered. Whether it's money or bread, success is not necessarily determined by size. Rather, success comes from a firm's ability to supply its product to the customer as he desires and to change with the customer's changing needs.

Fifth, branching does not appear to result in prices that differ from those of unit banks.

Sixth, branch banks and larger institutions do provide a wider array of financial services, especially in rural areas. While the number of institutions in a market may decline initially when branching is introduced, this trend will be reversed over time as entry occurs.

Based on these findings, the authors concluded, not surprisingly, that the standard criticisms of geographic expansion in banking are unconvincing. These authors do not stand alone. Our own experience indicates that broader banking franchises create stronger banks.

Thirty-three states now provide for regional or national full-service interstate banking. Twenty-six of these jurisdictions have passed regional interstate compact laws. Seven of these states have "trigger" laws, authorizing nationwide banking by a date certain. Three states -- New York, Alaska, and Maine -- already allow institutions from anywhere in the nation to enter and do business within their borders. By the end of 1988, at least 14 states will permit nationwide banking.

Michigan's recently enacted interstate banking law provides for regional reciprocal banking and for nationwide reciprocal banking starting in October 1988. I understand that Michigan bankers already are taking advantage of the law's new provisions. The largest and fifth largest banking organizations in Michigan have reached agreement to acquire sizable banks in Indiana -- one a half-billion dollar institution and another over $200 million in size.

What about the federal government's role? My view is that Washington should let the states develop their own interstate bank expansion plans. Each state can make its own decision based on its view of its own needs. Interstate banking developed with the consent of the banks will provide sounder policy in the long run than forcing the issue from Washington, D.C.

Congress in 1982 authorized the emergency interstate acquisition of failed banks with over $500 million in assets. This provision of the Garn-St Germain Act recently was extended by Congress, but it is due to expire on July 15. This provision was designed to reduce FDIC losses.

Now all the federal bank supervisors are asking that the law be broadened to allow failing as well as failed banks and holding companies to be acquired. Multistate auctions of failing banks heighten competition and maximize a bank's sales price. This reduces costs to the FDIC and thus to other banks around the country through a return to rebates on premiums. The new combined institutions tend to be healthier and more likely to succeed than mergers that result from purely in-state auctions.

This is not a federal mandate for interstate banking. This proposal affects only a small subset of banks. Furthermore, the states' interests are amply protected. Rebidding procedures would give in-state institutions the fullest opportunity to make an acquisition.

State law standards for determining whether a state-chartered bank is "failing" would be respected. Also, state authorities would be given notice and a chance to object to proposed out-of-state assistance transactions. These proposals will save Michigan bankers money if they can be enacted.

Interstate banking does make the bank supervisor's life a lot more complicated, both at the state and federal levels. The FDIC's Division of Bank Supervision is examining the special supervisory challenges posed by geographic diversification. Let me share with you the key questions we believe must be addressed.

How do we present a consistent regulatory response across regional and state boundaries in order to handle the logistics of exchanging information, coordinating examinations, and taking enforcement actions?

How do we assess risk and monitor company-wide activities that encompass different charters and regulators, ownership by foreign entities, and nonbank subsidiaries?

How do we monitor interstate transfers of assets within an organization that are aimed at concealing problems?

How do we deal with differences in accounting standards that can exist within financial organizations as they cross boundaries and acquire different types of institutions?

We don't yet have all the answers to these questions, but we are working on them. We will use the fruits of our research to guide our regional managers in organizing their supervisory efforts.

Unfortunately, competent supervision of banks deployed across state lines could be undermined if OMB gets its way and brings the federal bank supervisors under its control. OMB has claimed the right to apportion the FDIC's budget in letters to the Senate and House Banking Committees. It states it wants to be a policymaker in our area. It also maintains that Gramm-Rudman budget cuts apply to our agency, even though we don't get one red cent of the taxpayers' money. If OMB succeeds, the FDIC's historic bipartisan independence will be lost. Control of our operations will effectively pass from our Board and the Congress to OMB. OMB will simply tell the FDIC how much of the banking industry's money we can spend on supervision. Congress won't be able to influence that decision through the appropriations process since we do not use appropriated funds. Why do I predict trouble? Look at the disastrous results when OMB got control of the Federal Home Loan Bank Board's budget. Despite pleas for more supervisory funding as thrifts were deregulated, none were allowed by the Budgeters; the consequences were swift. A few thrifts went wild and later failed, and cost the FSLIC billions.

At this time, we are asking all our friends in the banking community to support Congressional legislation that would exempt us from OMB budget control. We want to remain responsive to your needs -- not the whims of those who have shown that they don't understand the banking industry's problems.

III. Conclusion

Thank you very much. As Charles Lindbergh remarked as he neared Paris at the end of his historic flight, "I have some gas left but I think I'll stop here."