

STATEMENT ON  
REGIONAL AND NATIONAL INTERSTATE BANKING

PRESENTED TO THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS  
SUPERVISION, REGULATION AND INSURANCE  
OF THE  
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

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Mr. Chairman:

I am pleased to have the opportunity to testify on behalf of the FDIC before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance on various issues relating to interstate banking.

We are all aware that limited de facto interstate banking has existed for some time. Entry to this market basically has been limited to the larger banks and bank holding companies, and has been accomplished in large measure by establishing offices or subsidiaries that do not have the word "bank" in their name or possess federal deposit insurance. These interstate facilities normally do not perform the full range of banking activities, but do provide a means for out-of-state banking organizations to compete in segments of local banking markets. They are known by such names as loan production offices, mortgage companies, consumer finance companies and Edge Act Corporations. Additionally, many industrial banks are owned by bank holding companies, and many of these are insured by the FDIC. To provide a measure of the magnitude of this activity, a 1983 study conducted by the Federal Reserve Bank of Atlanta identified approximately 7,600 interstate offices of banking organizations. Moreover, a physical market presence is not always necessary to compete for banking services; credit card and other loans and various correspondent banking services currently are the best examples, although advances in technology may significantly increase the importance of consumer electronic banking.

More recently, two other vehicles for entry into interstate markets have emerged. First, the willingness of the FSLIC to arrange interstate.

acquisitions of troubled savings and loan associations by bank holding companies provides an opportunity for banking organizations to acquire interstate subsidiaries that have very liberal deposit and investment authority. However, the activity that has received the most attention and raised the most controversy is the nonbank bank. Although the nonbank bank option does have advantages over the more limited service facilities, their importance relative to interstate banking is grossly overemphasized. Their importance probably relates more to the ability of nonbank firms to own entities that are called banks and are eligible for federal deposit insurance. While I personally do not think nonbanking ownership of banks should present any problem, it is a more significant departure from perceived tradition than the use of nonbank banks as a vehicle for interstate expansion.

All of the existing interstate options are imperfect substitutes for full service banking facilities, and undoubtedly result in inefficiencies that would not exist if full interstate banking existed. The economics of this situation argue for unlimited interstate banking, and the signals provided by the market indicate its inevitability. The only substantive questions relate to when and how.

Interstate banking, whether on a regional or national basis, has a variety of potential benefits that undoubtedly are familiar to this Subcommittee. Removal of barriers to entry generally serve to increase competition, reduce prices and improve the quality of products available to users of bank services;

this should tend to be beneficial to consumers and others who are limited to local banking markets. Moreover, geographic expansion affords an opportunity to reduce risk through diversification of deposit sources and lending opportunities. Rather than dwell on the virtues of interstate banking opportunities, I will direct the remainder of my comments to the purpose of this testimony, first focusing on the general area of geographic expansion and then on the regional pact concept.

As the deposit insurer, one of our major concerns relates to the effects of interstate banking on the safety and soundness of individual banks and the system as a whole. As indicated earlier, geographic expansion should afford the opportunity to diversify and to reduce risks. Although the benefits of geographic lending diversification should not be disregarded, perhaps the most significant risk reduction for many banks derives from building a more stable, retail deposit base. While this may mean that an increased number of banks compete for a relatively fixed amount of retail deposits in local markets, it could result in a reduction in the extreme funding vulnerability of a few institutions.

There is always the danger that banks or bank holding companies may be willing to pay unjustifiable premiums to gain an early entry into selected markets. While mistakes undoubtedly will be made, the need to capitalize acquisitions and the accounting treatment of premiums paid should provide a significant deterrent to unwise decisions. Moreover, as experience is gained in evaluating the potential of out-of-state markets, the tendency to pay a price above the economic value of a franchise should diminish.

Perhaps the greatest risk to the insurance fund of interstate banking emanates from the probable increased number of "large" banks and the potential for a significantly increased size of the largest banks. The statutory and, more importantly, the practical restraints placed on the FDIC normally mean that larger failed or failing bank situations are more difficult to handle than small to moderate sized banks, and can result in a proportionately larger exposure to loss. However, in a world of interstate banking, particularly if it is accompanied by strong antitrust enforcement, there probably would be a larger number of eligible potential acquirors in any size category, which may more than counterbalance the negative effects of increased bank size.

There also are other important public policy issues raised by interstate banking. One fear that frequently is raised relates to the fate of small banks in such an environment. The evidence we have seen suggests that small banks, at least those that are well-managed, will not be hurt by entry of out-of-state competitors. Available evidence suggests that economies of scale above a reasonably small asset size are not significant, and that smaller institutions generally have better returns than regional and money center banks. Moreover, in states that have long-standing statewide branching statutes, small independent banks continue to exist and usually earn returns above those reported by their larger competitors.

Perhaps the most important issue related to interstate banking concerns the concentration of economic power. In our judgment, current bank antitrust



laws and guidelines are sufficient to control undue concentrations in local banking markets. However, existing law and practice in the banking area are ill-equipped to deal with undue concentrations of economic power on a national level. Although there are a variety of ways to deal with the problem, we believe that legislation validating the "potential competition" concept, combined with a prohibition of a combination of the largest firms in the industry, would make sense. It seems desirable to encourage large banks to enter a market, but undesirable to allow that entry to occur by means of the acquisition of one of the dominant firms within that market if a "toehold" acquisition or de novo entry are viable alternatives. Likewise it does not seem desirable to allow a combination of two or more of the largest firms, even though their share of the aggregate market is relatively small and they do not compete in any common markets. Although the numbers and means of implementation need to be worked-out, we believe that this is a sensible way to approach the problem.

If the constitutionality of the Massachusetts-Connecticut reciprocal laws is upheld by the Supreme Court, regional pacts will be an important factor in determining the future structure of the banking system. While there are definite advantages to regional interstate banking as an interim step before authorizing full interstate banking, there are disadvantages in allowing this to happen without some Congressional guidance.

Although we have no problem with the regional pact concept -- indeed, they are probably desirable as an interim step in that they will allow regional

banks to strengthen their position in anticipation of nationwide banking -- there are potential concerns. One problem area comprises the substance of the case currently being considered by the Supreme Court; these pacts do discriminate against banks and holding companies headquartered in states excluded from the pact. A second area of concern relates to the possibility that the existence of regional pacts may delay or prevent full interstate banking. Banks participating in a pact will have the opportunity to consolidate their positions within the region, and some may not find it economically advantageous to expand beyond the regional level. There would be an incentive for those banks not wishing to expand further to resist any move that would expose them to competition from out-of-region banks.

In sum, we believe that interstate banking is both desirable and inevitable, and ultimately will work to the benefit of users of banking services. Moreover, there appears to be no safety and soundness problems that are not outweighed by the potential public benefits to be derived from the opportunities for increased competition and risk reduction. Our major concern relates to control of excessive concentrations of power within an interstate banking environment; we would not favor interstate banking that was not accompanied by stronger antitrust enforcement than currently exists. We also support the regional pact concept as a means to phase in full interstate banking, provided that consolidations within these pacts are governed by rules that ultimately result in a more competitive nationwide banking system.