

Background Paper 85-1

BANKING DEREGULATION AND
INTERSTATE BANKING

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I

INTRODUCTION

Banking, indeed the whole financial services industry, is in a state of transition. The distinctions among the various financial entities--banks, savings and loan associations, insurance companies, real estate brokers, securities broker-dealers, finance companies, and investment brokers--are blurring. The reasons for this are manifold. Technology, such as automated teller machines and other systems for electronically transferring money, has made certain banking services obsolete. High inflation and corresponding high interest rates have caused the elimination of many state and federal laws and regulations which pertain to usury limits and which appear to be counterproductive to the natural financial laws of supply and demand. There has also been a concomitant effort to deregulate many industries.

This background paper briefly reviews the changes occurring in one segment of the financial services arena--interstate banking. Because of the scope of the topic, however, the paper covers other changes in the financial services industry as well.

Banks, savings and loan associations, and related financial institutions operate under a complex system of federal and state regulation. To understand the operation of depository financial institutions, a review of the laws affecting them is necessary. This paper attempts to provide that review.

Before discussing banking deregulation and interstate banking, it may be helpful to provide a brief overview of the current status of Citicorp's interest in placing a credit card operation in one of the western states.

Citicorp, a large bank holding company headquartered in New York, recently attempted to influence the New Mexico legislature to amend that state's laws to facilitate Citicorp in establishing a major credit card center in New Mexico. The applicable legislation was killed in committee on February 6, 1984. Citicorp is continuing to encourage the passage of legislation pertinent to its interests. It is also considering operations in California and Nevada.

For purposes of this report, the following definitions apply:

Bank Holding Company: A parent company which controls one or more subsidiary banks. Generally the subsidiary banks, to avoid being classified as branches, must operate under separate charters, in which case each has its own capital base, separate banking facility and its own employees.

Branch Banking: A system of banking whereby a single bank has separate offices in different geographical areas. Full or restricted intrastate branch banking is permitted in more than three-fourths of the states. It appears Nevada law permits full intrastate branch banking.

Dual Banking System: A structure through which organizers of a bank in the United States may choose a state or federal charter. If the organizers obtain a state charter, the bank is required to comply with the laws and regulations of that state. Supervision is then provided by the particular state's banking authorities. If organizers obtain a federal charter, the bank must carry out business under federal law and regulations. It is then also subject to supervision by the Comptroller of the Currency.

Group Banking: Banking activities controlled through a bank holding company. Group banking overcomes some of the restrictions of "unit banking states." (See definition of unit banking below.)

Interstate Banking: Branch banking or group banking that occurs across state lines. Currently, "interstate branch banking" is illegal under federal law.

Intrastate Banking: Branch banking or group banking that occurs within a single state.

Unit Banking: A system whereby each individual bank conducts all of its operations at one office. "Unit banking states" are states, such as Colorado and Wyoming, which prohibit intrastate branch banking.

II

OVERVIEW OF THE CURRENT BANKING SYSTEM

There are approximately 14,000 separate bank operations in the United States. This is, in part, an effect of the dual system of regulation. This figure compares to only 11 banks in Canada which solely has a national system of regulation. While a large number of banks in the United States might indicate active competition, that is not necessarily the case.

The dual banking system in the United States had its origins during the Civil War. The National Bank Act of 1864, which was designed to finance the war effort, created a system of nationally chartered, but privately owned banks. The law required national banks to be unit banks. The dual system became a reality because very few existing state chartered banks opted to join the national system. Congress tried to encourage conversion through the imposition of a 10 percent tax on all notes issued by state chartered banks. This effort failed because the state banks devised an accounting system which eliminated the issuance of bank notes and thus the tax. The resistance to an exclusively national banking system carries over to today.

The early system of bank regulation performed satisfactorily until the epidemic of bank failures which followed the stock market crash in 1929. For a period of 3 years following the crash of the stock market, Congress processed legislation aimed at reforming the system of bank regulation.

The effort proved difficult because of diversity and differences in the bankers' interests. One noteworthy proposal which caused great concern among the state chartered institutions would have permitted interstate branch banking by national banks.

Franklin D. Roosevelt, upon becoming President, advocated bank reform legislation which later became known as the Banking Act of 1933. The act was passed with almost no advice or communication from bankers or other financial experts. It contained provisions relating to the chartering and operation of national banks, and expanded the powers of the Federal Reserve System. It also continued the prohibition against interstate branch banking contained in the National Bank Act.

Although the banking industry has undergone a dramatic metamorphosis in the last decade, banks generally remain bound by the geographic restrictions of the Roosevelt era.

Federal Banking Laws

The review of certain federal laws that govern current banking activities is necessary to understand the subject of interstate banking.

McFadden Act

The McFadden Act, enacted in 1927, governs branch banking of nationally chartered banks. It incorporates the branching limitations of each state and applies state law to national banks within the state's boundaries. Under the original act, if a

state allowed intrastate branch banking, then, for the first time, a national bank in that state was allowed to branch. Interstate branch banking, however, was strictly prohibited under the act.

The act created an interesting anomaly in the law. A national bank's branching was governed by state law, but the definition of a "branch" for national banks remained a question of federal law.

Glass-Steagall Act

This legislation, approved in 1932 near the height of the banking crisis, restricts the securities activities of commercial banks. It also prohibits investment bankers from certain commercial banking activities.

Present-day bankers appear to be eager to have this law modified or repealed. Banks remain limited, under the act, in the investment field to the buying and selling (discount services) of stocks and bonds.

Bank Holding Company Act

This legislation brought the regulation of bank holding companies (BHC) solely under federal jurisdiction. Enacted in 1956, the law requires that all BHC acquisitions, whether state or nationally chartered, fall under congressional control.

Through a holding company, several banks can operate under centralized control. As separate corporate entities, they practice what is known as group banking. Operation of multiple bank subsidiaries in such a manner does not constitute branch banking. As a result, many bankers have utilized the BHC structure as a method of circumventing the branching restrictions adopted by states which allow only unit banking. However, BHC's do not have unlimited freedom to operate banks in more than one state. Because of provisions in the Douglas Amendment to the Bank Holding Company Act, a BHC may only cross state lines to engage in group banking where the state into which entry is sought has specifically enacted legislation authorizing such activity. This limitation, it is said, is intended to support the maintenance of a competitive balance between the state and national banking systems.

Federal Laws Pertaining to Savings and Loan Associations

Some of the efforts to deregulate the banking industry have been strengthened because of recent changes in the laws and regulations governing savings and loan associations. With these

changes, savings and loan associations have moved into the same product market as banks. The following three laws have been the most important in effecting these changes.

Federal Home Loan Bank Act

The Federal Home Loan Bank Act, passed in 1932, empowered the Federal Home Loan Bank Board to regulate the savings and loan industry. Though the industry has a dual system similar to that of banks, the law did not subject federally chartered savings and loan associations to the same interstate branching restrictions as federally chartered banks.

Depository Institutions And Monetary Control Act of 1980

Savings and loan associations, unlike banks, were originally designed to be special purpose financial institutions. They were supposed to encourage savings and to provide, in part, financing for the purchase or construction of private homes. They were simultaneously prohibited from accepting demand deposits and making consumer loans. The Depository Institutions and Monetary Control Act of 1980 eliminated those prohibitions and thereby enabled savings and loan associations to perform many of the same functions for customers as banks.

Until 1981, the Federal Home Loan Bank Board had applied restrictive interstate branching guidelines to savings and loan associations. The Board abandoned this position on September 3, 1981, to help improve the industry's competitiveness. This action, combined with the provisions contained in the Depository Institutions and Monetary Control Act of 1980, temporarily gave savings and loan associations a competitive advantage over banks, which may not branch across state lines.

Garn-St. Germain Depository Institutions Act

The Garn-St. Germain Depository Institutions Act, signed into law in 1982, authorizes the restructuring of depository institutions which proponents believe will enable them to compete in today's financial environment. The law provides a federal assistance program for weak depository institutions, expands the powers of savings and loan associations regarding commercial and consumer loans, and creates a new instrument to enable depository institutions to compete with money market mutual funds. The law places restrictions on the interstate branching of federal savings and loan associations similar to those placed on national banks. It is felt, however, that the law fails to address the important question of the delivery of certain other financial services, including security activities, by depository institutions.

III

ACTIVITIES IN THE STATES

Current Nevada Law

Other than for First Interstate Bank, which was "grandfathered" in under the terms of the Bank Holding Company Act, Nevada does not permit interstate banking. The 1983 legislature, however, established a structure which would regulate out-of-state bank holding companies if they were to be allowed in the state. Subsection 4 of Nevada Revised Statutes 666.075 gives the administrator of the division of financial institutions the power to regulate the acquisition or organization of banks in Nevada by out-of-state bank holding companies. As noted earlier, Nevada also is one of approximately 21 states that allow unlimited intrastate branch banking.

Banking Deregulation in Selected States

In the absence of federal legislation to deregulate the banking industry, at least eight states have passed laws which allow, to varying degrees, out-of-state bank holding companies to establish banking activities within their borders. Five of the states' laws and pertinent policies are described below.

South Dakota

South Dakota viewed limited deregulation of interstate banking as an incentive for economic development. The state removed its usury ceilings in 1980 and then passed legislation which allows an out-of-state bank holding company to acquire a single new bank within South Dakota. This action was primarily taken to entice Citicorp to set up a credit card operation which is now employing over 1,000 persons. The state also has a "gentlemen's agreement" with Citicorp which restricts the company from competing with local bank business.

Other banks have followed Citicorp's lead. First National of Nebraska is moving its credit card operation to Yankton, South Dakota. Michigan National Bank of Lansing, Michigan, has chosen Rapid City, South Dakota, for its credit card division.

The 1983 South Dakota legislature also enacted legislation permitting out-of-state bank holding companies to acquire existing state chartered banks. The new law allows the acquired banks to sell insurance outside of South Dakota. Citicorp quickly acquired a bank in Rapid City, but its proposal to sell insurance is awaiting federal approval.

Delaware

Delaware, like South Dakota, modified its laws in order to enhance economic development. The legislature repealed the state's usury limits in 1980 and invited large banks into Delaware. The provisions of the new laws restrict the new out-of-state operators from competing with local banks. The out-of-state banks are limited to a single office in Delaware and cannot operate in a manner which produces a substantial disadvantage to existing banking institutions. These banks are also required to employ at least 100 persons in the state.

As an incentive for banks to locate in Delaware, income tax rates for banks with high levels of income were reduced. Because no local banks were in the specified tax brackets, the reduction in tax rates did not cause any reduction in the tax revenue to the state.

Many believe Delaware's initiatives to obtain new banking business have proven to be positive for the state. At least a dozen banks, including five of New York City's largest banks, have started operations. More than 1,500 new jobs have been created in the state.

Maine

Maine liberalized its bank laws in 1978. That legislation permits an out-of-state bank holding company to acquire Maine banks if a Maine bank holding company has reciprocal rights in the other state. The effect of this action has been minimal until recently because only Alaska conformed to the reciprocity requirement. With the passage of New York reciprocity legislation (see below), several New York bank holding companies have moved into the Maine market.

Alaska

It is said that Alaska's law pertaining to out-of-state bank holding companies doing business in Alaska is the most liberal in the Nation. The law permits a bank holding company from any other state to acquire a state bank, national bank, or bank holding company within Alaska. Some believe the law has had little effect because, according to John Ford, a reporter for the American Banker, Alaska does not have the capital resources to lure major banks into setting up new operations.

New York

The New York law pertaining to out-of-state bank holding companies is similar to Maine's. Effective June 1982, the law

authorizes the acquisition of one or more banking institutions located in New York by an out-of-state bank holding company. The statute also permits acquisition of newly organized banks. The acquisition, however, can only occur if the laws of the state in which the acquiring bank conducts its business offer reciprocal rights to New York. If one accepts the premise that large banks have an edge in interstate banking, this provision is in New York's favor because New York is home to many of the largest banks in the Nation.

Other States

Three New England states, Connecticut, Massachusetts and Rhode Island, have recently liberalized their banking laws to allow reciprocity within New England only. Rhode Island, however, will permit reciprocity from any state after 2 years. New England, whether through formal or informal legislative actions, may become a testing ground for regional interstate banking.

At least four additional states--Florida, Illinois, Iowa and Maryland--allow some out-of-state bank operations within their borders. For example, several New York banks have set up trust operations in Florida. In addition, North Carolina National Bank expanded its presence in Florida through a subsidiary bank which predated the Douglas Amendment.

IV

THE DEBATE OVER DEREGULATION

The changing dynamics of the financial marketplace have seriously curtailed the effectiveness of federal and state laws and regulations which govern the Nation's financial system. Many nonbank financial firms, because of improved computer technology and flexibility based upon the minimal regulations placed on them, have successfully begun to provide services which traditionally have been offered only by banks. The banking industry, which for so long neither competed with nor faced competition from other businesses, now favors at least some deregulation to expand its own options.

Deregulation of the banking industry can affect the products and services it offers or the geographic areas in which it operates. There appears to be little argument within the banking industry about the deregulation of its products and services. Bankers believe that the various financial services are beginning to overlap and that efforts to artificially segment the industry

will prove futile. The banking industry, moreover, desires to compete with related industries which offer insurance and brokerage services.

It is perceived that insurance companies and brokerage operations would prefer that banks not be permitted to compete with them. Certain observers are also concerned that competition of this nature could pose a threat to the safety and soundness of banks.

Product deregulation is largely an issue which rests with Congress and the various federal regulatory agencies. More important to the states is the issue of geographic deregulation, specifically interstate banking.

There is considerable disagreement within the banking industry and among states regarding interstate banking deregulation. The arguments are similar to those expressed in the 1930's when the issue was first debated. The conditions, however, have changed considerably.

Arguments Against Interstate Banking

Opponents contend that most financial assets in the Nation will gravitate to a few large banks with the expansion of interstate banking. They argue that this would hurt consumers because a few industry giants could dictate terms of credit. Experience in states with unlimited intrastate branch banking appears to indicate that a certain amount of asset consolidation does occur. For example, the number of banks in North Carolina fell from 100 to 17 in the 20 years after it allowed branch banking. There is, however, no research which shows that intrastate consolidation has created restrictive or unduly expensive conditions for banking customers.

Another feared result of interstate banking is that consolidation will mean less money available for local loans. The Independent Bankers Association claims that it has surveys which show that small businesses and other types of bank customers obtain an overwhelming percentage of their loans from local independent banks.

Opponents of interstate branching also argue that branch offices will not be able to offer the same kind of personal attention and intimacy based upon longstanding relationships with customers as will the small locally owned banks. This concern was stated by Alex Sheshunoff during a 1976 United States Senate hearing before the Subcommittee on Financial Institutions:

Banking is very much of a public trust, and often that public trust is best administered locally with a bank that

is responsive and responsible to the local community. You have local ownership, local directors, and people that live in that community. They have to be responsible to the members of that community and not branch managers passing through town on their way up some corporate ladder.

Opponents further argue that a structure with several independent banks provides greater diversity and credit judgment than a system with only a few banks where loans are predicated on the same lending criteria. This assertion, however, remains unproven.

A final argument of particular interest to state legislatures is that interstate banking will mark the death-knell of the dual banking system. With interstate banking, the need for state regulatory systems may be called into question. States could find it very difficult to monitor the health and activities of a bank with branches in other states.

Arguments in Favor of Interstate Banking

Proponents argue that interstate banking will increase competition. They acknowledge that a consolidation of resources will occur. They add, however, that the power of big banks will not prove overwhelming to their competitors. They point to the example of California which has long allowed intrastate branch banking. The state still has many strong independent banks despite the presence of Bank of America and other major banks.

The proponents claim that the current geographic barriers are, by nature, anticompetitive. The current restrictions are said to erect protective walls around small banks which often enjoy monopoly or near monopoly status within their market areas. Proponents cite studies showing that rates paid on deposits and the rates and terms of credit are more favorable in states which permit intrastate branching. In addition, the banks in states which allow branch banking generally have lower net profits.

Advocates say interstate banking improves services to customers. It is said that larger financial institutions can offer more services because of economies of scale. One study found that an average of five new services were provided with every merger of a unit bank into a branch bank. The study also said, however, that "the new services were not particularly beneficial to the local communities * * *."

Supporters of interstate banking point out that in attempting to expand into new markets, they must compete with established banking relationships. They believe that a small, well run bank has a clear advantage over a new competitor. To support

this contention, they cite the case of certain banks in upstate New York which effectively countered competition from the big New York City banks after the liberalization of New York's laws relating to intrastate branch banking.

On the issue of whether interstate banking will reduce or eliminate state control of banks, proponents argue that interstate banking will actually strengthen the dual banking system. The essence of the system lies in the ability of each state to set its own banking policy. Proponents contend that interstate banking by itself does not eliminate this system which allows banks to choose between state and federal laws, regulations, and supervising agencies.

The proponents acknowledge, however, that interstate banking will make it more difficult to monitor the activities of interstate banks. They claim that necessary regulation could be accomplished through interstate compacts or some form of uniform code. The same technology that facilitates interstate banking could provide the means for interstate regulation, proponents say.

IV

CURRENT FEDERAL DIRECTION

There appears to be support for banking deregulation at the federal level. Legislators and regulators recognize that some deregulation has occurred in fact, if not in law. They are aware that the banking environment has changed considerably. They have concluded that attempts to return conditions to those of an earlier era would prove either counterproductive or futile. The scope and time frame of deregulation continue to be subject to much debate, however.

The Carter Administration prepared a report on the McFadden Act entitled Geographic Restrictions on Commercial Banking in the United States, The Report of the President. The report contains a considerable amount of data to support its conclusions. A clear dissatisfaction with current statutes and case law relating to banks emerged. Even small bankers, feeling competitive pressures from savings and loan associations, credit unions, and other nonbank financial institutions, expressed a desire for reform. The report concludes "that existing geographic limitations * * * (are) * * * an anachronism in the marketplace of the 1980's."

The report recommends a reasoned and careful approach in modifying the laws relating to banks. Suggestions include modification of

the Douglas Amendment to allow interstate expansion through bank holding company acquisitions and the eventual direct out-of-state branching by banks. The report also recommends that electronic fund transfer systems be eventually excluded from the provisions of the McFadden Act. The change could initially permit this type of "branching" only within natural market areas with nationwide expansion occurring later.

The report also recommends legislation which would permit interstate acquisitions of failing institutions. This would be similar to the situation allowed for distressed savings and loan associations by the Federal Home Loan Bank Board. As an early step in deregulation, it is thought that this action could add strength and stability to the banking industry.

Although the report was issued by the Carter Administration, the Reagan Administration shows no signs of slowing the move toward liberalization of the geographic limitations on banking.

The most controversial deregulation issue at the federal level concerns permitting banks to venture into product areas traditionally denied to them. Much of the impetus for keeping banks distinct and carefully regulated stems from the widespread bank failures of the 1920's and 1930's.

Those who want to restrict deregulation in the product area, including the Federal Reserve Board, argue that suppliers of capital need to be protected from risk. It is claimed that this protection will diminish if banks are allowed to expand their activities to include the sale of insurance and the providing of brokerage services.

Supporters of product deregulation, which include the Treasury Department, say that the regulators are trying to preserve outdated practices. They note that many unregulated concerns have ventured into banking activities without severely disrupting the financial industry. They also point out, for example, that considerable legislative protection did not help the savings and loan associations during the recent period of high inflation.

The issue is now being contested within the current legal framework, but most experts agree that congressional action rather than regulatory reinterpretation is needed. A possible compromise solution which is being considered would allow banks to provide ancillary financial services through subsidiaries, thus keeping banking activities separate and distinct.

OPTIONS FOR NEVADA

Several options are said to be available to Nevada. Included among those options are:

1. The state could leave things as they are and wait until Congress begins the task of shaping the structure of the financial industry.
2. The state could make some minor modification of its laws to allow out-of-state banks to conduct limited banking activities.
3. The state, similar to Connecticut and Massachusetts, could allow reciprocity within a limited geographical area.
4. The state, similar to Maine and New York, could allow nationwide reciprocity.
5. The state, similar to Delaware and South Dakota, could allow limited out-of-state branching into Nevada for purposes of economic development.
6. The state, similar to Alaska, could allow out-of-state bank holding companies to acquire state or national banks within Nevada.
7. The state could allow unlimited branching from out-of-state banks or bank holding companies.

Within the context of options 3 through 7, the state could determine whether the branching applies to existing banks, new banks, or both. In addition, the state could grant the out-of-state firms the right to venture into nonbanking activities.

Options 2 through 7 all implicitly send a message to Congress and federal regulators that Nevada supports a move forward on the issue of bank deregulation. Alternatively, the state could, through a joint resolution, petition the federal authorities to leave the banking laws as they are or to proceed with deregulation.

VI

CONCLUSION

The issue of bank deregulation has become increasingly complex. The actions of the states which have passed various deregulation legislation have prompted interstate friction and even some lawsuits. The federal authorities realize that some changes will probably be necessary, but few actions have been taken. The future configuration of those businesses providing financial services depends greatly on federal action. The states, however, are increasingly taking the initiative and thereby contributing significantly to the decisionmaking process.

VII

SUGGESTED READING

Selected State Laws

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Prepared by the Office of Research
February 15, 1984