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TWO CHEERS FOR THE BANKING REFORM BILL

INTRODUCTION

Americans have always worried about concentrations of power. Fearing the concentration of political power, the Founders created a three-pronged system of government; fearing a concentration of financial power, Congresses since the creation of the Republic have erected various legal impediments to networks of banks. Other nations generally allow their banks to open branches throughout the country, just as Wal-Mart, Allstate Insurance, or any other type of business can operate across state lines here. By contrast, the United States has restricted banks' ability to cross state borders, creating a banking system unique among developed countries.

Increasing competition among many types of financial institutions, and between rival banks, has reduced the fear of concentration significantly in recent years. To consumers who see familiar banking names in several states, it may appear that interstate banking already has arrived. But banks still face important limits when they cross state lines. This has the effect of reducing the intensity of competition in some areas, leaving banking power more concentrated in those cities and towns. Briefly, a corporation (known as a bank holding company, or BHC) may own banks in several states, and may even call them by the same name, but they are not offices of the same bank. This distinction shows up most clearly in limits on the services they can provide consumers.

In a move that would benefit both the banking industry and its customers, Congress seems poised at last to remove many of these remaining barriers. The House of Representatives in March passed H.R. 3841 to allow interstate branching, and the Senate approved a similar bill, S. 1963, in late April. The two measures now are being taken up by a House-Senate conference before final congressional action.

Interstate banking though often proposed, has never progressed very far. Most recently, branching liberalization was part of former President George Bush's unsuccessful 1991 banking reform proposal. Owners of small community banks traditionally have been the most powerful opponents of interstate banking.[1] Until the 1980s, their opposition pre-

1 Throughout U.S. history the owners of small banks have wielded much more political power than the more-feared large bankers. This is not surprising given that branching restrictions meant that every Congressman had one or more small banks in his district, and the owners and officers of these small banks

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

served branching restrictions which strictly limited competition for local bank customers. The insurance industry also has played an important role in slowing interstate banking. It has stymied recent reform efforts, for instance, by attaching to interstate banking bills amendments that would limit banks' ability to sell insurance. The banking industry was unwilling to trade reduced powers for greater branching freedom, so reform measures failed.

Opposition from these traditional foes has faded, however. Branching restrictions no longer protect local banks from competition as advancing communications technologies and innovative "nonbank" financial service companies, such as mutual funds and finance companies, have provided businesses and individual consumers with an increasing range of financial choices. In addition, current interstate banking bills were given a boost when Senator Christopher Dodd (D-CT) announced in February that he would not insist on coupling restrictions on banks' insurance sales to branching liberalization.[2] Consumer groups remain the most outspoken opponents of interstate banking because of fears that banks will collect deposits in one area and use the funds to make loans in places other than the communities in which the depositors live.

The current legislation on interstate branching is not as complete as some analysts would like. For instance, it does not remove many of the restrictions on the products that banks are permitted to offer customers. These are deficiencies in the legislation. Still, the bill expected to emerge from Congress over the next few weeks would benefit both the banking industry and consumers of banking services. The large number of bank failures during the 1980s demonstrated yet again that banks with widespread branches generally are more stable than "unit" banks (banks with no branches).[3] In addition, allowing today's interstate banking operations to change their many separate banks into offices or branches of a larger banking organization would save an estimated $10 billion-$15 billion annually. Consumers who cross state lines would find banking services more readily available and convenient, and consumers could expect a more competitive banking industry to develop if this legislation becomes law.

The banking reform bill thus would mean greater stability for the banking system without the greater concentration that Americans fear. It would mean more competition and more services, to the benefit of the consumer, and it would stimulate greater efficiency in the banking sector.

A BRIEF HISTORY OF INTERSTATE BANKING

U.S. banking history has been shaped largely by a continuing struggle between the states and the federal government over who should charter and supervise banks.[4] Early attempts by the federal government to become involved in banking were short-lived. The

often were influential members of the community. See Eugene N. White, "The Political Economy of Banking Regulation," *Journal of Economic History*, Vol. 42 (March 1982), pp. 33-40.

2 Jerry Knight, "Interstate Banking Gets Unexpected Boost in Congress," *The Washington Post*, February 4, 1994, p. B1.

3 Bank failures during the 1980s occurred disproportionately in those states with more restrictive branching laws.

First Bank of the United States was established in 1792 and operated branches in eight states; in 1811, Congress declined to renew its charter. The Second Bank of the United States was chartered in 1816 and eventually operated 25 additional offices; its charter was allowed to expire in 1836. This ended the federal government's involvement in banking until 1863.

The federal government reentered banking during the Civil War. The National Currency Act of 1863 established a system through which banks could obtain "national" charters from the federal government.[5] It was revised and strengthened by the National Bank Act of 1864, which established the Office of the Comptroller of the Currency within the Department of the Treasury to issue charters and supervise nationally chartered banks. Nationally chartered banks were not allowed to establish branches, however, although state-chartered banks that converted to national charters could keep any branches they already had.

Throughout the late 18th and early 19th centuries, various Comptrollers of the Currency urged Congress to grant nationally chartered banks broader branching powers. The McFadden Act, passed in 1927, did allow nationally chartered banks to operate branches within the city in which they were located if state-chartered banks had similar (or broader) powers, but wider freedom to branch still was denied to banks.

The bank failures of the 1930s brought the issue of branching to the forefront of national banking policy debates again. Between 1929 and 1933, some 9,000 banks closed in the United States, but these failures were not distributed randomly. Banks without branches were almost twice as likely to fail during the period leading up to the Depression as banks with branches.[6] Significantly, in Canada, where banks could branch nationwide, there were no bank failures despite depressed economic conditions similar to those in the United States.[7]

These lessons were not lost on U.S. observers. Between 1930 and 1935, fifteen states liberalized the branching laws within their borders.[8] In addition, the Roosevelt Administration promoted interstate branching, at least within "trade areas," as a response to the banking crisis that gripped the country.[9] At the federal level, however, fears of excessive concentration still thwarted interstate banking, and a proposal to institute federal deposit

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4 An entrepreneur cannot simply decide to open a bank. An aspiring banker must obtain a "charter," or permission to open and operate a bank, from the appropriate government authority.

5 In addition to establishing a uniform national currency, the banking acts of 1863 and 1864 required nationally chartered banks to buy U.S. bonds as collateral backing their bank notes. With the U.S. government at war at the time, there was an abundance of these bonds available.

6 David L. Mengle, "The Case for Interstate Branch Banking," Federal Reserve Bank of Richmond *Economic Review*, Vol. 76 (November/December 1990), p. 7.

7 Another difference was that Canada did not have a central bank, but the performance of the Federal Reserve System during the Depression is beyond the scope of this study.

8 Carter H. Golembe and David S. Holland, *Federal Regulation of Banking 1986-87* (Washington: Golembe Associates, 1986), p. 134.

9 The Baltimore/Washington/Richmond area would have been considered an economic "trade area" in this sense. Large amounts of commerce and individuals regularly cross state lines within this economically integrated region that includes parts of two states and the District of Columbia.

insurance won the day.[10] Moreover, the Banking Act of 1933 amended the McFadden Act to make nationally chartered banks subject to the branching laws of the states in which they operated. In some 22 states, that meant no branching whatsoever. Only nine other states allowed branching anywhere within the state, and the others retained various limitations.[11] There was no branching permitted across state lines. Thus, Depression-era legislation clearly established the states as the level of government to determine how much branching would be permitted.

The most recent restrictive step in U.S. interstate banking history occurred in 1956. During the early 1950s, bank holding companies became more important as bank owners attempted to get around limits on where and how they could operate.[12] With the Bank Holding Company Act of 1956, the federal government sought to more clearly define the limits to bank holding company activities and their ability to expand geographically. Thus, the Douglas Amendment to the Bank Holding Company Act of 1956 prohibited BHCs from acquiring banks in other states unless explicitly permitted to do so by the state of the acquired bank.

With the Douglas amendment in place and state policy makers inclined to protect in-state bankers from out-of-state competitors, there was virtually no interstate banking permitted in the United States from 1956 until 1975,[13] when Maine passed a reciprocal interstate banking law allowing an out-of-state bank holding company to acquire a Maine bank if Maine BHCs had the same ability to acquire banks in the acquiring BHC's home state.

In the early 1980s, other states copied the Maine legislation and began passing interstate banking laws.[14] Many required reciprocity, as Maine did. Others, meanwhile, limited out-of-state acquisitions to nearby states through regional compacts. As the decade progressed, interstate banking laws generally became more liberal as states further relaxed restrictions on who could acquire in-state banks.[15] Today, only Hawaii does not have some form of interstate banking statute. Fifteen states and the District of Columbia allow regional interstate banking, 21 states permit reciprocal nationwide acquisitions, and thirteen states allow interstate acquisitions with no restrictions.[16]

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10 Helen Burns, *The American Banking Community and New Deal Banking Reforms, 1933-1935* (Westport, CT: Greenwood Press, 1974).

11 Mengle, *op. cit.*, p. 6. These data are based on the state laws that existed in 1929.

12 Bank holding companies also can own certain nonbank financial firms.

13 Banks were allowed to establish limited-service offices across state lines to serve large corporate customers or international clients.

14 During the early 1980s, the deregulation of interest rates banks could pay depositors, coupled with increasing competition from nonbank financial firms, reduced the protection traditionally enjoyed by local bankers. Many more bank owners became interested in selling their banks, and allowing interstate acquisitions increased the pool of potential buyers.

15 Existing state interstate banking laws generally require entry by acquisition rather than allowing an out-of-state bank holding company to enter a state by establishing a new bank. Such provisions no doubt made interstate banking more palatable to owners of existing banks.

16 "Interstate Banking and Branching Act of 1994," *Report of the Committee on Banking, Housing, and Urban Affairs, United States Senate*, Report No. 103-240, March 23, 1994, p. 6.

These interstate banking arrangements did not involve branching, however. Bank holding companies are allowed to acquire banks in more than one state, but they cannot consolidate operations across state lines into a single bank. Indeed, in states without statewide branching, a bank holding company may be required to operate several separate banks within a single state. Banks owned by a single BHC in different states may use the same name, but across state lines they are not the same bank. The legislation in both the House and the Senate is designed to remove these remaining restrictions.

What the Legislation Would Do

The House of Representatives passed its interstate banking bill, the Interstate Banking Efficiency Act of 1994 (H.R. 3841), in March. The Senate's Interstate Banking and Branching Act of 1994 (S. 1963) was passed April 26. The provisions of the two bills, now headed to conference, are similar. Among the key provisions:

1) One year after enactment, both bills would preempt remaining state-sponsored barriers to interstate acquisitions.

Thus, adequately capitalized and managed bank holding companies would be allowed to acquire additional banks anywhere in the country (with regulatory approval). BHCs would still be required to operate these new acquisitions as separate banks until the second stage of the reform is reached. In the second stage, multistate bank holding companies would be allowed to combine their various bank subsidiaries into a single bank with branches in several states. The House bill would begin this second stage eighteen months after enactment of the legislation; the Senate bill calls for a three-year delay.

Both the House and Senate give the states the option to override the federal preemption of state laws, in whole or part, by opting out of interstate banking and/or branching. In other words, a state legislature could decide either that out-of-state bank holding companies could not acquire banks in that state (Hawaii's current stance) or that out-of-state BHCs must continue to operate banking offices as separate subsidiary banks rather than as branches within that state.

The House bill gives the states three years to decide whether to opt out of interstate banking and/or branching. The Senate bill places no time limit on states' ability to opt out, although it does stipulate that any interstate combinations approved by regulators before a state opted out would be grandfathered. In both bills, banks seeking to branch into a new state would be allowed to do so only through the acquisition of an existing bank unless the state specifically allowed banks to establish *de novo* (new) branches. Once in a state, a bank would be subject to the branching laws of that state.

2) The House and Senate bills also establish concentration limits for bank acquisitions.

The House bill forbids any acquisition that would place 30 percent of insured deposits within a state under the control of a single bank, while the Senate prohibits acquisitions that gave one bank or bank holding company control over 25 percent of a state's insured deposits. Both bills prohibit acquisitions that would give one banking organization control over more than 10 percent of insured deposits nationwide.

3) Supervision of multistate banks would not differ much from current practices.

Multistate banks that choose to operate under a national charter would continue to be supervised by the Comptroller of the Currency under both bills. The Federal Reserve System would still examine state-chartered Federal Reserve member banks, and the Federal Deposit Insurance Corporation would continue to oversee the activities of state-chartered nonmember banks. In the legislation, state-chartered banks also are made subject to supervision by the "chartering state," or by the banking authorities of the state in which the bank is headquartered.

4) The House bill contains two special provisions that are viewed by consumer groups, such as the Consumer Federation of America and the Consumers Union, as particularly important.

The first means that branches operated across state lines would be subject to the consumer protection laws, fair lending requirements, and branching restrictions of the states in which they operate unless the state law was preempted specifically by federal law. These requirements would apply to the branches of both nationally chartered and state-chartered multistate banks. Under the Senate bill, branches would be subject to state laws unless the Comptroller of the Currency overrode state consumer protection laws for branches of nationally chartered banks for safety and soundness purposes. The second House provision requires banks planning to close a branch to include in branch closing notices the name and address of the primary regulator of the bank so that consumers could contact the regulator with their concerns. The House bill includes other provisions assuring that community groups can meet with bank regulators to seek ways to fill any void left by a branch closing.[17]

WHY AMERICANS WILL GAIN FROM THE LEGISLATION

The new banking legislation will provide important benefits to consumers and to the American economy. Among them:

1) Interstate branching will lead to a more stable banking system.

The United States has suffered more bank failures than any other developed country. It is easy to see why. Bank failures in Texas and Oklahoma during the 1980s represent just one recent example.

Where banks are not allowed to branch, the financial health of an institution depends entirely on the economic health of the town or region it serves. Consider a bank in Texas or Oklahoma in the early 1980s.[18] Many parts of each state were heavily dependent on the oil industry. While oil prices were high, these areas boomed. When oil prices began to fall, however, many energy-related businesses failed. As exploration and drilling slowed,

17 No community wants to lose banking services, of course, but moves to slow a bank's efforts to close branches do more than affect the bank's financial health. They also discourage other banks from ever opening branches in questionable locations. Easy exit is essential to promoting entry.

18 Both Texas and Oklahoma were unit banking states at the time.

suppliers suffered losses and found themselves unable to meet loan payments. Individuals employed on oil rigs lost their jobs, and consumer loans soured. Consumer spending in local clothing stores, restaurants, and car dealerships fell, raising questions about loans to these businesses. A unit bank that focused solely on these communities thus became very vulnerable. There was no profitable part of its business available to offset the losses on loans.

By contrast, branched banks have more diversified loan portfolios and sources of deposits so that losses at one branch often are offset by profits elsewhere. It might appear that the current holding company form of interstate banking has captured the advantages of diversification. This is true only for the holding company, not for the individual banks, since each bank's loan portfolio remains concentrated in its local market. This has raised legal questions about the financial obligations of a healthy bank toward an insolvent institution owned by the same holding company. Such issues seldom arise in a branched network. Similarly, the closing of an unprofitable bank within a holding company structure is much more complicated than the closing of a branch. When a branch is closed, the bank's continuing obligations to depositors and good loan customers are clear.

2) Interstate branching would reduce multistate banks' costs and increase their efficiency.

Operating separate subsidiary banks in each state leads to considerable duplication within multistate banking operations. Legally separate banks require separate boards of directors, separate reports to regulators, separately audited financial statements, and separate examinations, to name a few areas of duplication. NationsBank alone estimates that through interstate branching it would save $50 million per year by eliminating overlapping and duplicative regulatory and administrative costs.[19] The Senate Banking Committee estimates that for banks nationwide, annual pretax savings could amount to $10 billion-$15 billion.[20] These savings would reduce the costs of the banking industry, increasing its stability. The funds thus made available could be used to expand lending opportunities for businesses and consumers, to lower interest rates charged for loans, or to reduce banking fees to consumers.

3) Interstate branching would lead to a more efficient payment system.

Transactions within the United States are complicated by the current banking structure. Companies with widespread offices often must deal with several different banks as they collect and disperse funds in the course of doing business. Frequent transfers of funds between banks are common as corporate headquarters offices consolidate revenues and distribute payments. The number of interbank payments necessary would be reduced if corporations operating across state boundaries could deal with a single interstate bank, as they can in most countries competing with the United States. This would reduce the costs of cash flow management in commercial enterprises and the cost of running the payment system, thus reducing the cost of providing checking services.

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19 Kenneth H. Bacon, "Nationwide-Bank Bill Picks Up Steam As Even Opponents See Measure Passing," *The Wall Street Journal*, February 25, 1994, p. A3.

20 "Interstate Banking and Branching Act of 1994," p. 11.

4) Consumers would benefit from interstate branching.

Interstate branching would lead to more convenience for consumers. Some four million U.S. workers commute daily across state lines.[21] Interstate branching would allow these consumers to conduct their banking business either where they live or where they work. They could withdraw cash, make deposits, transfer funds, apply for loans, or raise questions about their bank statements wherever it is most convenient. Similarly, individuals who travel to other parts of the country would have increased access to banking services when away from home, and individuals who move from one state to another would no longer necessarily have to establish a whole new banking relationship.

There is an even more important advantage to consumers, however: interstate branching will increase competition within the banking industry.[22] For 200 years, opponents have raised the specter of reduced competition if branching and interstate banking are allowed. For the average consumer, effective competition is not determined by the number of banks in the country but by the number of banks with offices in his or her town. Permitting full interstate banking would increase competition dramatically. Local bankers have enjoyed real monopoly power in the past because many markets were too limited to support an additional separately capitalized, full-service bank. But it costs much less to open a branch than to open a whole new bank. Therefore, interstate branching will increase the number of bank offices in many local communities even as it reduces the number of separately incorporated banks in the country. Furthermore, the number of local markets with effective competition should increase as branching spreads.

DEFICIENCIES IN THE LEGISLATION

Opponents of interstate branching often express concern that offices of multistate banks lose their local focus, their dedication to serving members of local communities. Senator Ben Nighthorse Campbell (D-CO) observes that "In Colorado, some consumers complain that when branches of interstate banks replace longstanding local banks, those consumers lose specialized services and access to loans."[23] Congress could address such concerns by allowing banks to enter new markets by opening new branches (known as *de novo* branching), which would be better than requiring that banks enter by purchasing an existing bank, as specified in the current legislation. This would increase competition without requiring that expansion automatically eliminate a local competitor. Congress could enhance competition even further by granting adequately capitalized and managed banks blanket authority to open branches at their own discretion without applying for regulators' approval.

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21 Kenneth H. Bacon, "Nationwide Bank Bill Clears Senate Panel," *The Wall Street Journal*, February 24, 1994, p. A2.

22 It is this increased competition that would assure that consumers shared in the benefits of reduced banking costs resulting from interstate branching.

23 "Interstate Banking and Branching Act of 1994," p. 26.

In addition, interstate branching is just one part of the reform needed to modernize the U.S. financial structure on the eve of the 21st century. Important questions remain about the types of financial products and services banks are allowed to offer their customers and banks' ability to adapt to changing market conditions. There are also important issues surrounding bank owners' ability to decide how best to structure their businesses. Just as BHCs have long faced barriers to interstate branching, their ability to integrate traditional banking services with other financial products continues to be restricted by legal and regulatory firewalls. This hinders banks' ability to offer their customers convenience through one-stop shopping. The legislation, unfortunately, is largely silent on these important matters.[24]

CONCERNS ABOUT INTERSTATE BRANCHING

Opposition to interstate branching this year has come primarily from consumer groups. The Consumers Union, the Association of Community Organizations for Reform Now (ACORN), the Consumer Federation of America, and the American Association of Retired Persons (AARP) are among the groups who oppose the legislation as currently written.[25]

Opponents of interstate banking have long argued that cross-state branching would allow banks to drain deposits from some communities to enrich others. This argument is misleading for many reasons. First, bank deposits already move among banks—from those with fewer lending opportunities to those with more good loan demand.[26] Interstate branching will make this flow of funds less costly, but it will not introduce anything fundamentally new. Second, it is impossible to predict which communities or states will be net providers of deposits and which will be net users of deposits. Communities experiencing economic growth generally need to draw on outside financial resources, and the transfers of deposits between banks and between branches of banks is an important means of accessing those resources. Without such access to outside capital, growing areas tend to be held back.

Removing branching restrictions would improve the ability of banks to serve local customers. Under existing laws and regulations, two important constraints can limit banks' ability to make certain loans. The first is the capital standards applied to banks.[27] The second is the limits on the size of loan any single bank can make.

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24 For a discussion of firewalls, see William G. Laffer III, "How to Reform America's Banking System," Heritage Foundation *Backgrounder* No. 810, February 26, 1991, and Laffer, "A Guide to Current Banking Reform Legislation," Heritage Foundation *Issue Bulletin* No. 167, September 30, 1991.

25 See, for example, Bacon, "Nationwide-Bank Bill Picks Up Steam As Even Opponents See Measure Passing," p. A3.

26 The "federal funds market," consisting of overnight loans between banks, is one important way some banks help fund the lending activities of others. More directly, a bank making a very large loan may sell "shares" of the loan to other institutions. Banks "participating" in such loans thus can diversify their portfolios. Banks selling participation in their loans gain by freeing funds they then can use to make additional loans or investments.

27 Market advocates' first impulse is often to question the government's role in establishing capital standards at all. This issue is largely beyond the scope of this study; but as long as banks' deposits are guaranteed by the

Capital requirements define how much of the owners' money must stand behind banks' loans and other investments. These requirements are expressed as a percentage of total assets (or bank investments).[28] Consider a bank in a region suffering a local economic downturn—a New England bank in the late 1980s, for example, or a California bank today. As loans sour, these losses are written off against capital.[29] When capital (or owners' equity) is reduced, banks must reduce the size of their loan and investment portfolios to remain in compliance with regulatory standards. In the multibank holding company world that exists today, losses suffered by one bank are not offset by profits of other banks within the bank holding company. Thus, in the absence of new capital, a bank may be forced to reduce its lending activities despite being owned by a profitable BHC.

Interstate branching would change this. The costs and revenues associated with operating any branch would be added to those of other branches to determine the financial health and capital requirements of the bank as a whole. Banks operating branches nationwide could offset the losses suffered in one part of the country with profits earned elsewhere. Consequently, they might not be required to raise new capital to continue their lending activities. The end result could well be less regional economic volatility than the United States traditionally has experienced. As John McCoy, chairman and chief executive of Banc One Corporation, recently explained:

> [The interstate banking] legislation will lessen regional economic downturns, such as the one that hit New England several years ago. It is clear that in New England the downturn was made much worse because weakened banks were forced to shrink their loan portfolios as their capital levels fell because of losses. Interstate banking, it is now recognized, would have enabled banks to better withstand regional loan losses and to continue providing credit to job-creating businesses in New England.[30]

The ability of individual banks to provide loans to local customers is limited in another way. To assure diversity in its portfolios, a bank's loans to a single borrower may not exceed 10 percent of its capital. Once again these standards are applied to each individual bank, regardless of whether or not it is part of a bank holding company. Lending limits become a potential problem when a bank customer's borrowing needs grow with a growing business. An individual bank still may be able to originate and service a large loan if it can sell shares of the loan to other banks. Interstate branching would make it easier for a bank to continue meeting the needs of growing business customers, however, because lending limits would be applied to the entire banking organization rather than to a single office.

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federal government, the government, as the ultimate bank creditor, must set capital standards.

28 There are several interrelated capital standards. In general, banks must maintain capital equal to 8 percent of risk-adjusted assets to be considered "adequately" capitalized. Adjusting assets for risk means, roughly, that less owners' money is needed to back cash in the vault or Treasury securities than to back loans to businesses and individuals.

29 In addition to encouraging more careful bank management, bank capital is important because it absorbs losses that otherwise would be passed along to the deposit insurance fund or to uninsured depositors.

30 John B. McCoy, "Don't Blow Chance to Strengthen Banks," *The Wall Street Journal*, March 9, 1994, p. A12.

CONCLUSION

Passage of interstate branching legislation would benefit the banking industry and consumers of banking services. It would not mean the death of the small, locally owned bank. Just as locally owned clothing stores compete effectively with Sears, well-managed local banks would be able to hold their own in many markets by focusing on the special needs of local customers.

Interstate branching would introduce much-needed competition in these local markets. It would provide new sources of capital for fast-growing areas and bring new stability to banks in regions suffering economic problems. This reform, which would give the U.S. banking system the same incentives for stability and efficiency as enjoyed by banks in competing countries, would be a boon both to consumers and to American business.

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