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Report to the Chairman, Committee on
Banking, Housing, and Urban Affairs
U.S. Senate

November 1993

INTERSTATE BANKING

Benefits and Risks of Removing Regulatory Restrictions



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1. The first part of the document discusses the importance of maintaining accurate records of all transactions and activities. It emphasizes that this is crucial for ensuring transparency and accountability in the organization's operations.

2. The second part of the document outlines the various methods and techniques used to collect and analyze data. It highlights the need for a systematic approach to data collection, ensuring that all relevant information is captured and properly documented.

3. The third part of the document focuses on the analysis of the collected data. It discusses the various statistical and analytical tools that can be used to identify trends, patterns, and correlations in the data. It also emphasizes the importance of interpreting the results of the analysis in the context of the organization's goals and objectives.

4. The fourth part of the document discusses the implications of the analysis and the actions that should be taken based on the findings. It highlights the need for a proactive approach to problem-solving and the importance of implementing effective strategies to address the identified issues.

5. The fifth part of the document provides a summary of the key findings and conclusions of the study. It reiterates the importance of maintaining accurate records and the need for a systematic approach to data collection and analysis. It also emphasizes the importance of interpreting the results in the context of the organization's goals and objectives.

6. The sixth part of the document provides a list of references and sources used in the study. It includes a variety of academic journals, books, and other sources that provide additional information and support for the findings and conclusions of the study.

7. The seventh part of the document provides a list of appendices and supplementary materials. These materials include additional data, charts, and tables that provide further detail and support for the findings and conclusions of the study.

8. The eighth part of the document provides a list of acknowledgments and thanks. It expresses appreciation to the individuals and organizations that provided support and assistance during the course of the study.

9. The ninth part of the document provides a list of contact information for the author and other individuals involved in the study. This information is provided to facilitate communication and further research.

10. The tenth part of the document provides a list of other related works and publications. These works provide additional information and support for the findings and conclusions of the study.



United States
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General Government Division

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November 2, 1993

The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate

Dear Mr. Chairman:

Your May 19, 1992, letter requested that we report on the impact of proposed changes in laws concerning interstate banking and branching. This report responds to your request.

As arranged with the Committee, unless you announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies of this report to all Members of the House Banking Committee as well as other appropriate congressional Committees, federal banking agencies, and other interested parties. We will also make copies available to others upon request.

This report was prepared under the direction of Stephen C. Swaim, Assistant Director, Financial Institutions and Markets Issues. Other major contributors are listed in appendix IX. If you have any questions, please call me on (202) 512-8678.

Sincerely yours,

A handwritten signature in cursive script that reads 'James L. Bothwell'.

James L. Bothwell
Director, Financial Institutions
and Markets Issues

Executive Summary

Purpose

The United States is the only major industrial country that places geographical restrictions on its banks. Many industry observers have called for removing or relaxing these restrictions, and bills currently are pending to do this. To assist in its evaluation of this issue, the Senate Committee on Banking, Housing, and Urban Affairs asked GAO to provide information and analysis on the effects of interstate banking and branching.

This report concentrates on the following three areas: (1) the impact of interstate banking on the structure of the banking industry; (2) the implications of removing interstate banking and branching laws on the safety and soundness of the banking industry, the Bank Insurance Fund, and the economy; and (3) the risks associated with removing interstate banking and branching laws and ways to minimize such risks.

Background

Historically, banks in the United States have been restricted from expanding geographically because of concerns that such expansion would depersonalize banking relationships, drain savings from local economies, and result in excessive concentrations of economic power. Such concerns are, in part, why the banking system in the United States is composed of over 11,000 banks. These banks operate either under national charters granted by the Comptroller of the Currency or under charters granted by states.

Banking companies can expand geographically either by establishing bank branches or subsidiaries. Bank branches are offices of the bank and, as such, do not have separate capital requirements. Bank subsidiaries are separately chartered and regulated institutions that are part of bank holding companies. In addition to bank subsidiaries, bank holding companies consist of a parent and often some nonbank subsidiaries, such as thrifts, finance companies, mortgage companies, and data processing firms.

Current law permits in-state branching in most states but effectively precludes interstate branching for national banks and almost all state-chartered banks. The McFadden Act of 1927 allows national banks to branch throughout their home states if the states permit branching by their own banks. However, the act generally prohibits interstate branching for national banks and for all state-chartered banks that are members of the Federal Reserve System. Together these banks account for about 74 percent of the banking industry's assets.

State law governs interstate branching by state-chartered banks that are not members of the Federal Reserve; with a few minor exceptions, no interstate branching has been allowed to date. All but 13 states allow both national and state-chartered banks to branch freely within their states, but only a few states permit branching across state lines.

Banking companies can use the bank holding company structure to avoid the restrictions placed on branching and expand their interstate operations by acquiring banks in different states. However, this type of expansion is also subject to federal and state restrictions. Specifically, the Bank Holding Company Act of 1956, through a provision known as the Douglas Amendment, prohibits bank holding companies from establishing or acquiring a bank in another state unless such action is specifically permitted by the state the bank holding company wants to enter. And almost every state, to some degree, has restrictions or conditions that govern this type of interstate banking.

Recent legislative proposals have focused on relaxing or removing these interstate banking and branching restrictions. Supporters of a nationwide interstate banking and branching law argue that these restrictions no longer make sense in today's integrated financial and credit markets. Restrictions, they contend, limit American banks from competing with foreign banks, pose greater risks to the banking system and the Bank Insurance Fund (because they limit the extent to which banks can diversify), reduce competition within the industry, and increase consumer costs because of inefficiencies. Those who oppose geographic expansion or support limited expansion believe that increased interstate banking will lead to excessive concentrations of economic power and adverse effects on banking customers and local economies.

Results in Brief

Many states have relaxed their restrictions on interstate expansion of bank holding companies, and much interstate banking is occurring as a result. Removing federal interstate banking and branching restrictions would further encourage the growth of larger, more geographically diversified banking companies. The extent to which interstate banking would increase as a result of passing a nationwide interstate banking and branching law would depend on the extent to which state banking laws are overridden, the strategic business decisions of bankers, and the actions of state and federal regulators.

Increased interstate banking is leading to increased concentration of assets at the national level as large banking companies continue to acquire or merge with banks in other states. Concentration of assets at the state and local levels, however, increases only as a result of mergers and acquisitions among banks that are in the same states or local markets. Banks with assets of less than \$1 billion have been able to maintain their national market share despite the growth in the size of the largest banking companies.

Removing interstate banking and branching restrictions could benefit the safety and soundness of the industry, the regulatory process, and many bank customers. However, removing such restrictions poses risks as well. Problems can arise if banks are not well managed and well regulated, concentration levels of assets increase significantly, or credit availability is reduced to those bank customers whose borrowing needs are not easily met elsewhere.

The risks to safety and soundness can be minimized by restricting interstate expansion to well-managed and well-capitalized banks and by properly implementing the early closure and safety and soundness provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991.

The best way to minimize the risks to the quality and availability of banking services is to ensure that markets remain competitive through vigilant antitrust enforcement and that laws and regulations governing credit availability are adequately enforced. Additional regulatory authority may be needed to address any unanticipated consequences resulting from increased interstate banking.

GAO's Analysis

Over time, the relaxation of restrictive state banking laws has contributed to a substantial increase in the amount of interstate banking in the United States. Almost 25 percent of the country's \$3.5 trillion in banking assets are held in out-of-state subsidiaries of domestic banking companies and foreign-owned banks. However, differences in state banking laws have contributed to considerable state-by-state variation in the extent of out-of-state ownership. In 16 states plus the District of Columbia, more than 40 percent of each of the states' bank assets are owned by banking companies headquartered out of state. By contrast, in 13 states, less than 10 percent of each of the states' bank assets are owned by out-of-state banking organizations. (See pp. 48-51.)

Impact on Market Structure

Increased interstate banking has contributed to a substantial consolidation of the U.S. banking industry and led to an increase in overall industry concentration. From December 1986 to December 1992, the number of independent banking companies in the United States declined almost 20 percent, from 10,620 to 8,794, while the percentage of banking assets controlled by the 3 largest banking companies—a measure of overall industry concentration—increased from 12.8 percent to 14.4 percent. (See pp. 27-30.)

There is no direct relationship between increased interstate banking and changes in the state and local concentration levels of the three largest banking companies. Between 1986 and 1992, those concentration levels increased in 32 states but declined in 7 of the 16 states with the highest proportion of out-of-state ownership of banking assets. The average concentration levels of the three largest banking companies in local banking markets did not change between 1980 and 1991. (See pp. 57-62.)

Increased interstate banking does not necessarily mean a reduced role for smaller banks. Between 1986 and 1992, banks with assets of less than \$1 billion, measured in 1992 dollars, maintained a national market share of about 20 percent and increased their market share in 9 of the 16 states with a relatively large amount of interstate banking. However, these banks have no guarantee of a stable or expanding market share. Their continued viability will depend on such factors as their abilities to serve their communities, the efficiency of their management, their desire to remain independent, and the acquisition strategies of larger banks. (See pp. 62-67.)

Safety and Soundness Implications

Interstate banking and branching can provide opportunities for individual banking companies and the banking system as a whole to benefit from reduced costs, expanded market opportunities, and greater diversification of risks. However, the extent of these benefits and whether they will improve a banking company's performance will depend largely on how well the banks are managed. The safety and soundness of large interstate banking companies are of particular importance because the failure of such banks could seriously harm the Bank Insurance Fund and local economies. The risk of such harm would be minimized if interstate expansion is restricted to well-capitalized and well-managed banks. (See pp. 74-77.)

One potential benefit of nationwide banking and branching is that it may help reduce deposit insurance costs by enabling more banks to acquire weak or failing banks before they actually fail. Another benefit is that banking companies can become stronger by increasing the geographical diversification of their assets and liabilities, while reducing the cost of such diversification as a result of a more simplified banking structure. Increasing core deposits by expanding geographically could also lower banks' funding costs and reduce susceptibility to runs. It is not possible to generalize how interstate branching, by allowing interstate bank holding companies to convert bank subsidiaries into branches, would affect the holding companies' net income. Some bank holding companies have estimated that interstate branching would create potential cost savings equal to about 4 percent of net income. (See pp. 77-79.)

The complicated organizational structures of bank holding companies that have occurred in part because of the existing restrictions on interstate branching also require supervision by a large number of federal and state regulatory agencies. If banks could establish branches across state lines, their bank holding companies could consolidate their operations and reduce the number of their bank subsidiaries. If as a result, the number of different bank charters in a bank holding company declined, then fewer regulatory agencies—and perhaps fewer bank examiners as well—would be responsible for overseeing the subsidiaries of a particular holding company. In addition, because many bank holding companies are already centrally managed, simplifying their organizational structures could enable examiners to more easily assess risks for the holding company as a whole. (See pp. 93-99.)

GAO previously has identified regulatory delays in addressing known bank problems, problems with bank management and internal controls, and weaknesses in large bank and bank holding company supervision. These problems should be addressed before any relaxing of federal interstate banking restrictions occurs. In particular, proper implementation and enforcement of the early closure and other safety and soundness provisions in the Federal Deposit Insurance Corporation Improvement Act of 1991 is vital to ensuring that additional industry consolidation does not strain the resources of the Bank Insurance Fund. (See pp. 91-92.)

Implications for Bank Customers and Local Economies

Many bank customers—commercial and retail—could benefit from interstate banking and branching as a result of (1) the wider range of products and services typically offered by larger banking companies;

(2) the reduced need to maintain separate accounts for customers who bank across state lines; and (3) the improved accessibility of banking offices. However, not all customers would benefit from such changes. Some communities and small businesses could experience disruptions in established lending relationships when local banks are acquired by out-of-state companies. (See pp. 102-104.)

Concerns have also been raised that interstate banking and branching could harm local economies if large, interstate banks use deposits from local areas to fund loans in other parts of the country. Although some communities could experience temporary disruptions in credit relationships when there are changes in local bank ownership, the movement of funds within the country is essential to the functioning of a dynamic economy. GAO found no basis for concluding that interstate banking would systematically result in the diversion of funds from creditworthy local borrowers, as long as credit markets remain competitive. (See pp. 108-113.)

Regulatory Oversight Needed

To help prevent potential problems from increased interstate banking, the antitrust statutes as well as those laws and regulations concerning credit availability must be enforced vigilantly. Although relevant economic markets are often difficult to define, effective antitrust enforcement in bank mergers is essential to ensuring that markets continue to operate competitively. As half of the nation's 318 metropolitan areas are already dominated by 3 or 4 banks, oversight of antitrust enforcement will be necessary regardless of whether federal interstate banking restrictions are removed. (See p. 126.)

For competition to exist, it is also important that entry into the banking industry through new charters should not be inhibited by excess regulation or other high costs. New entry increases the likelihood that competition will exist to provide credit and meet other banking needs that might otherwise go unfulfilled amid consolidation. (See pp. 137-140.)

There is widespread concern that some banking needs—particularly the credit needs of low-to-moderate income borrowers—are not being adequately met even in competitive markets. The Community Reinvestment Act of 1977 addresses this concern by requiring banks to help meet the credit needs of their communities. How a bank is judged to perform its responsibility under this law is an important consideration in the merger approval process and can help improve any potentially adverse

consequences of bank consolidation on credit availability. Currently, a bank is given only one performance rating for all of its operations. Unless these rating requirements are modified, interstate branching would make it more difficult to assess a bank's lending performance in local communities if a bank's operations covered large regions or the entire nation. (See pp. 120-123.)

Recommendations

GAO is making no recommendations in this report.

Agency Comments

GAO requested comments on a draft of this report from the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Department of the Treasury. The Federal Deposit Insurance Corporation and the Department of the Treasury provided written comments, which appear in appendixes VII and VIII respectively. The Federal Reserve and the Office of the Comptroller of the Currency did not provide us with written comments, but in discussing the report with us, they made technical comments, which have been incorporated where appropriate.

The Federal Deposit Insurance Corporation indicated that as a general matter it supports the relaxation of geographic and product restraints on banks, provided that the states continue to play a role in the transition. It pointed out that the Bank Insurance Fund has absorbed major losses in rescuing banking organizations with assets concentrated in a few industries or in a limited geographic area. Also, it stated that these banking organizations may have been better able to withstand the problems in their local and regional markets if they had been more geographically diversified. GAO addresses this issue in chapter 4 of this report.

The Department of the Treasury stated that it had no formal comments but found the report to be an impressive and thoughtful survey of the issues and evidence.

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Abbreviations

BIF	Bank Insurance Fund
CAMEL	capital adequacy, asset quality, management, earnings, and liquidity
CRA	Community Reinvestment Act of 1977
EC	European Community
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
FIRREA	Financial Institutions Reform, Recovery and Enforcement Act of 1989
HHI	Herfindahl-Hirschman Index
HMDA	Home Mortgage Disclosure Act
OCC	Office of the Comptroller of the Currency

Introduction

This report was prepared in response to a request from the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs that we assess the potential impact of changes in federal laws affecting interstate banking and branching. The report concentrates on three areas:

- the impact of interstate banking on the structure of the banking industry;
- the implications of changing interstate banking and branching laws on the safety and soundness of the banking industry, the Bank Insurance Fund (BIF), and the economy; and
- the risks associated with changing interstate banking and branching laws and ways to minimize such risks.

Background

The subject of interstate banking and branching is important not only because commercial banking is a major U.S. industry but also because of the credit and other services banks perform in the U.S. economy. Commercial banks employ about 1.5 million people, or approximately 1.3 percent of the U.S. labor force, and hold between 20 and 25 percent of the credit assets in the United States.

U.S. banks operate under a dual banking system, in which banks may be chartered and regulated by (and subject to the laws of) both federal and state governments. These laws have helped to determine the structure of the U.S. banking industry by encouraging the chartering of thousands of banks, limiting the powers of those banks, and creating geographic barriers to consolidation among them.

The Structure of the Banking Industry

Bank holding companies—consisting of a parent company and its subsidiaries—are the dominant form of banking structure in the United States, accounting for approximately 94 percent of the assets in the nation's banking system (see table 1.1). Most bank holding company assets are in commercial bank subsidiaries, but bank holding companies may also own a variety of other companies, including thrifts and mortgage and finance companies.¹ Bank holding companies were established for a variety of business, regulatory, and tax reasons, but they have been particularly effective in overcoming geographic restrictions imposed by

¹Some of the largest bank holding companies hold more than 20 percent of their assets in subsidiaries other than commercial banks.

federal and state law by establishing sometimes dozens of bank subsidiaries that to some extent have substituted for bank branches.²

Table 1.1: Number of Commercial Bank Holding Companies and Independent Banks and the Percentage of U.S. Banking Assets in These Institutions

Dollars in billions				
Banking companies	Number of banking companies	Number of banks owned	Banking assets	Percentage of banking assets
Multibank	886	3,542	\$2,631	75.5%
One-bank	4,770	4,770	644	18.5
Independent	3,138	3,138	212	6.1
Total^a	8,794	11,450	\$3,486	100.0%

Note: Data are for the period ending December 31, 1992.

^aNumbers may not add due to rounding.

Source: Call report data.

Commercial banks may be either subsidiaries of bank holding companies or independently owned. Bank subsidiaries are separately chartered institutions that are subject to the same regulation and capital requirements as individual institutions. As of December 31, 1992, there were 11,450 federal and state-chartered commercial banks in the United States.³ These banks held about \$3.5 trillion in assets, principally in securities and loans. Insured deposits, which amounted to almost \$2 trillion as of December 31, 1992, funded more than 50 percent of these assets.

Commercial banking companies—multibank holding companies, one-bank holding companies, and independent banks—vary greatly in size.⁴ Most are relatively small, but the largest rank among the nation's largest and most complex multinational companies. Smaller banking companies, those with less than \$1 billion in assets—referred to in this report as community

²Bank subsidiaries often serve as deposit-gathering arms for their bank affiliates by collecting deposits locally and selling or transferring them to bank affiliates located in larger urban areas through interbank deposits or the federal funds market.

³Of these, 3,600 held national charters and were regulated and supervised by the Office of the Comptroller of the Currency (OCC), and 7,850 were state chartered. State-chartered banks are regulated jointly by the states and either the Federal Deposit Insurance Corporation (FDIC) or the Federal Reserve. Some 6,895 state-chartered, non-Federal Reserve member banks were regulated and supervised by FDIC, while the Federal Reserve was responsible for the 955 state-chartered, Federal Reserve member banks.

⁴Banking companies are defined as the number of independent banking entities. Banks within a multibank holding company are considered part of the same banking company and are thus counted as one banking company in this report.

banks—account for 97 percent of the total banking companies in the United States but only 21 percent of industry assets. By contrast, about 62 percent of the banking industry's assets are controlled by the 56 banking companies that have \$10 billion or more in assets (see table 1.2).

Table 1.2: Asset Size of Commercial Banking Companies

Size of banking companies	Banking companies		Assets	
	Number	Percentage of total	Total	Percentage of industry total
\$10 billion or more	56	0.6%	\$2,144	61.5%
\$1 billion-\$10 billion	188	2.1	593	17.0
\$100 million-\$1 billion	2,053	23.4	481	13.8
Less than \$100 million	6,497	73.9	268	7.7
Total^a	8,794	100.0%	\$3,487	100.0%

Note: Data are for the period ending December 31, 1992.

^aNumbers may not add due to rounding.

Source: Call report data.

Interstate Banking and Branching

The power to determine how banking companies may branch within states or expand across state lines—either through branching or bank subsidiaries—has largely been ceded by Congress to the states. Primarily as a result of legislative action by all states except Montana and Hawaii, a significant amount of interstate banking has already taken place.⁵ (App. I includes a more detailed discussion of the history of interstate banking and the branching restrictions and factors affecting the structure of the U.S. banking industry.)

Branching

Under the McFadden Act of 1927 and the Banking Act of 1933, state laws determine how banks, including national banks, may branch within each state, provided that national banks are given the same rights as state-chartered banks. Branches are bank offices and are regulated as integral parts of the bank. As a result, they do not have separate capital requirements, and transfers of assets and liabilities among branches and

⁵Montana enacted regional reciprocal legislation granting interstate banking that took effect October 1, 1993.

between branches and the headquarters bank are not restricted.⁶ The number of banking offices (i.e., bank subsidiaries and bank branches) peaked in 1991 at 64,003 and consisted of 11,906 banks and 52,097 branches. In 1992, the number of banking offices declined by 508.

Although many states originally passed restrictive in-state branching laws, most states have liberalized these laws in recent years. Whereas in 1986 eight states prohibited branching of any kind, today none do. Now 37 states plus the District of Columbia, which account for about 83 percent of the nation's banking assets, permit statewide branching.⁷ The other 13 states restrict branching to some degree.

Although states were given full authority to determine the in-state branching powers of all banks within the state, interstate branching is prohibited by the McFadden Act for all banks except state-chartered, non-Federal Reserve member banks, of which there were 6,895 as of December 31, 1992. State law governs the ability of these banks, which account for about 15 percent of U.S. banking assets, to branch interstate. Four states currently permit reciprocal interstate branching: New York, Oregon, Alaska, and North Carolina. Nevertheless, with a few minor exceptions, no interstate branching has been undertaken to date.

Interstate Banking

Section 3(d) of the Bank Holding Company Act of 1956, commonly known as the Douglas Amendment, left open the possibility of interstate expansion through bank holding companies. The Douglas Amendment prohibits bank holding companies from acquiring a bank in another state unless the state the bank holding company wants to enter specifically permits such entry. The practical effect of the amendment is that state statutes, not federal law, determine where bank holding companies can go.

The purpose of the Douglas Amendment was to help alleviate concerns that economic power could be concentrated among a relatively small number of nationwide banking institutions and to keep national and state-chartered banks on an even footing by giving states, not the federal government, the authority over interstate banking.⁸ Nevertheless,

⁶Although branches do not have separate capital requirements, a bank's capital requirements may be influenced by the number and location of its branches.

⁷See appendix II for information on state branching laws and the percentage of national banking assets held in those states.

⁸The Bank Holding Company Act also restricted the activities in which multibank and later one-bank holding companies were allowed to engage.

interstate expansion through the use of bank holding company subsidiaries continued after the Douglas Amendment was passed and has gained momentum in recent years as can be seen by the following examples:

- As of December 31, 1992, a majority of U.S. banking assets were owned by 190 banking companies that operate bank subsidiaries in more than one state. Approximately two-thirds of these assets were held in the banking companies' headquarters states, and one-third was held out-of-state.
- In 1992, about one-fourth of U.S. banking assets (23 percent) were held in out-of-state subsidiaries of domestic bank holding companies or in foreign-owned banks.⁹
- In 10 states and the District of Columbia, out-of-state banking companies owned 50 percent or more of the states' banking assets.
- The nonbank activities of bank holding companies, which are not restricted by the Douglas Amendment, gave some larger banking companies a physical presence in virtually every state.

The magnitude of this interstate activity can be explained primarily by the enactment of interstate banking statutes at the state level, as authorized under the Douglas Amendment. Maine was the first state to pass such a law in 1975, and other states followed. By early 1993, all but two states, Montana and Hawaii, permitted some form of interstate banking.¹⁰ Most states—34 plus the District of Columbia—permit bank holding companies to enter from any state, either on a reciprocal (i.e., nationwide reciprocal) or nonreciprocal (nationwide) basis. These states account for 76 percent of the assets in the U.S. banking industry. The remaining 14 states restrict interstate entry to bank holding companies from their own geographic region as defined by the state (i.e., regional reciprocal). (See table 1.3.) The major regional areas have included New England, the Southeast, the Midwest, and the West.¹¹ Figure 1.1 shows current state laws on interstate banking.¹²

⁹Approximately 18.6 percent of the nation's banking assets were owned by domestic out-of-state bank holding companies. Another 4.7 percent were owned by foreign banking companies.

¹⁰Montana enacted a regional reciprocal law that took effect October 1, 1993. Montana, however, has several banks that are part of multistate bank holding companies. These companies were established before the Douglas Amendment was passed and were grandfathered in the Bank Holding Company Act of 1956.

¹¹For additional discussion of regional compacts and the development of state laws permitting interstate banking, see appendix I.

¹²Within each category of interstate banking laws, details of the laws may differ. For example, definitions of the same compacts vary by state because each regional reciprocal state defines the states to which it grants reciprocity.

**Chapter 1
Introduction**

Table 1.3: Interstate Banking Laws by State

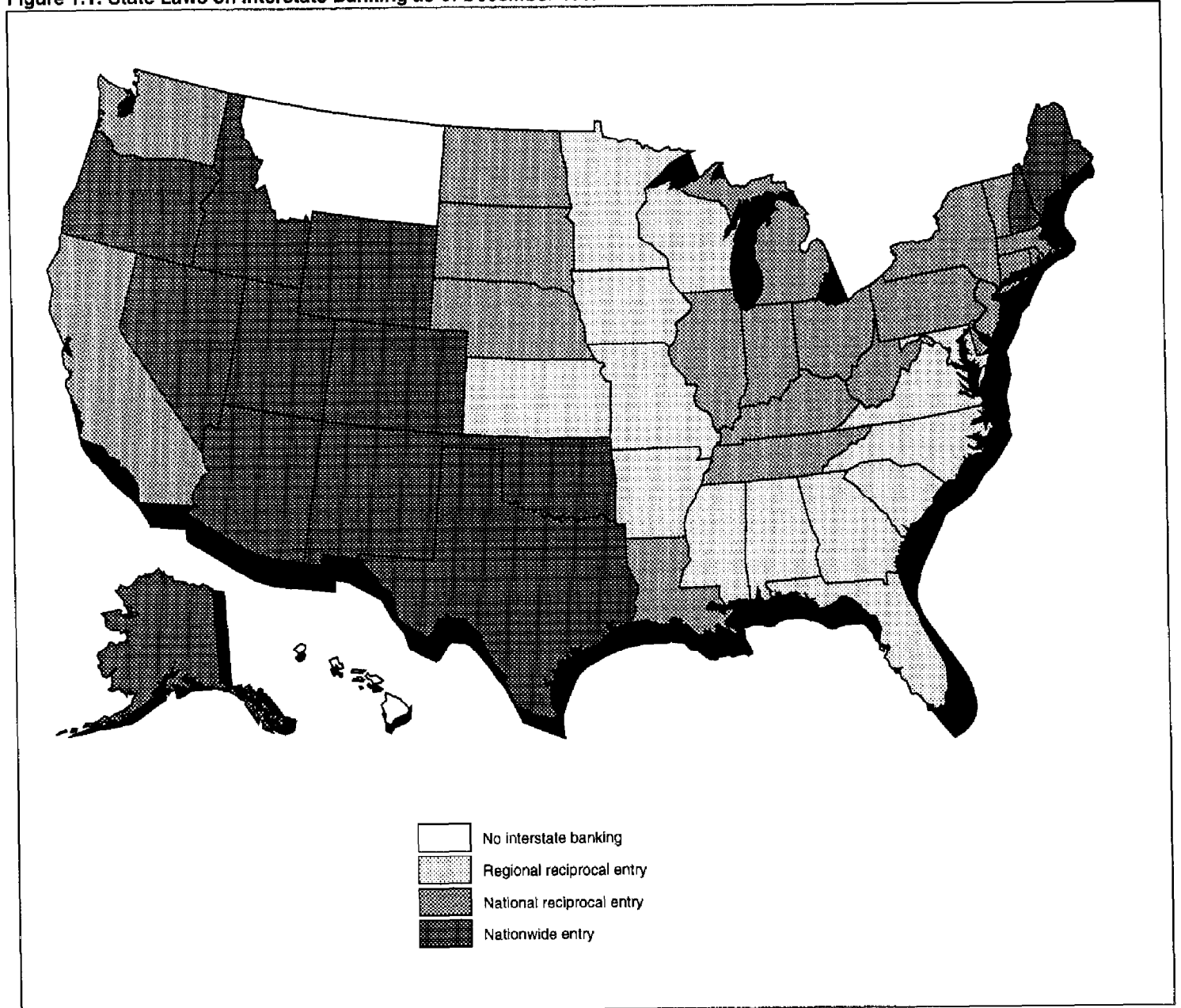
Nationwide	Nationwide reciprocal	Regional reciprocal	None
Alaska	California	Alabama	Hawaii
Arizona	Connecticut	Arkansas	Montana ^a
Colorado	Delaware	Florida	
District of Columbia	Illinois	Georgia	
Idaho	Indiana	Iowa	
Maine	Kentucky	Kansas	
Nevada	Louisiana	Maryland	
New Hampshire	Massachusetts	Minnesota	
New Mexico	Michigan	Mississippi	
Oklahoma	Nebraska	Missouri	
Oregon	New Jersey	North Carolina	
Texas	New York	South Carolina	
Utah	North Dakota	Virginia	
Wyoming	Ohio	Wisconsin	
	Pennsylvania		
	Rhode Island		
	South Dakota		
	Tennessee		
	Vermont		
	Washington		
	West Virginia		

Note: Data are for the period ending December 31, 1992.

^aMontana enacted a regional reciprocal banking law that took effect on October 1, 1993.

Source: Federal Reserve and the Conference of State Bank Supervisors data.

Figure 1.1: State Laws on Interstate Banking as of December 1992



Source: Federal Reserve data.

Even before states moved to permit interstate banking, bank holding companies were free to expand interstate through their nonbank subsidiaries. Banks could also cross state borders by establishing insured nonbank banks, Edge Act Corporations, and loan production offices.¹³ In addition, concurrent with the movement by states to permit interstate banking, the Garn-St Germain Act of 1982 and the Competitive Equality Banking Act of 1987 authorized the interstate acquisition of failed banks and thrifts.¹⁴ In some states, this type of interstate entry has been of some significance in explaining interstate acquisition patterns.

Geographic Restrictions Are Unique to Banks in the United States

Of the major financial services providers in the United States, only the banking industry faces interstate restrictions. The banking industry's principal competitors—including securities firms, investment banks, insurance companies, savings and loans, and finance companies—all may operate nationwide.¹⁵

Interstate restrictions are not only unique to banks but also unique to the United States. No other major industrialized nation prohibits banks from branching within its borders. Partly as a result of these restrictions, the U.S. banking system is much less concentrated than systems in many foreign countries. In December 1988, the five largest commercial banking companies in the United States held 15 percent of all commercial bank

¹³Before 1987, insured nonbank banks were able to offer only limited banking services—they did not both accept demand deposits and offer commercial loans—to avoid subjecting the parent company of the nonbank bank to the Bank Holding Company Act and other banking laws and regulations. Existing nonbank banks were grandfathered under 1987 legislation that changed the definition of banks eligible for deposit insurance (see app. I for additional discussion).

Edge Act Corporations may engage in international or foreign banking or other international or foreign financial operations. They were designed to stimulate the provision of international banking and financing services throughout the United States.

Loan production offices provide closer geographic proximity between loan officers and potential borrowers. They are not permitted to take deposits, however, or offer most of the other services of full-service banks.

¹⁴The Garn-St Germain Act of 1982 permitted out-of-state bank holding companies to acquire large, troubled commercial banks and insured mutual savings banks and authorized the interstate acquisition of failed thrifts. The Competitive Equality in Banking Act of 1987 liberalized and extended those provisions and authorized FDIC to arrange interstate takeovers of institutions with assets of more than \$500 million. In addition, some states enacted their own laws, allowing out-of-state banks to acquire failing in-state institutions.

¹⁵Securities firms, investment banks, and insurance companies must be licensed to do business in each state in which they operate. Other than this requirement, there are no geographic restrictions imposed upon them by the regulators. The Office of Thrift Supervision removed regulatory restrictions on branching by federal savings associations in a ruling effective May 11, 1992. Finance companies and nonbanks are not subject to federal regulations covering capital guidelines or constrained by geographic expansion barriers.

deposits compared with 31 percent in Germany,¹⁶ 32 percent in the United Kingdom, 36 percent in Italy, and 57 percent in France.

U.S. banks also play a much smaller role in the economy than banks in the European Community (EC)—again, partly as a result of interstate and product line restrictions imposed on U.S. banks.¹⁷ The ratio of bank assets to gross domestic product is about twice as large in Germany, the United Kingdom, and France as it is in the United States, and major U.S. banks are smaller compared with the five largest U.S. industrial companies than banks in EC countries are compared with their largest domestic industrial firms.¹⁸

Recent Banking Industry Trends Reflect a More Competitive Environment

The banking environment has changed quite substantially since the laws restricting interstate banking and branching were passed. Both large and small banks operate in market environments that have become very competitive, and the industry as a whole is consolidating.¹⁹ These changes are partly the result of interstate banking statutes and partly the result of other factors.

Banking Companies Are Experiencing Growing Competition

Throughout the 1970s and 1980s, banking companies faced intensifying competition from both within the banking industry—as states liberalized their in-state and interstate banking restrictions—and from other financial services providers. The following are a few facts that illustrate the extent of competition among banking companies:

- The vast majority of banking companies may be acquired by any other banking company in their state. Only 13 states, which account for 17 percent of the nation's banking assets, place any restrictions on branching within the state. Even in these states, no banking company is

¹⁶These data exclude eastern Germany.

¹⁷When viewed from the perspective of a unified market, the market structure for the 12 countries composing the EC looks a great deal less concentrated and more like that of the United States. As of December 31, 1988, for example, the five largest EC banks comprised 15 percent of the total EC banking assets, compared to 14 percent for the five largest U.S. banks. Comparisons between the 10 largest EC banks and U.S. banks reveal similar results.

¹⁸The ratio of the five largest domestic banks to the five largest domestic industrial companies is 98 percent in the United States compared with 780 percent in France, 463 percent in Germany, and 313 percent in the United Kingdom.

¹⁹In this report, the term consolidation is used to describe a reduction in the number of banking companies, not necessarily in banking industry assets.

protected from acquisition by at least some banking companies.²⁰ (See app. II for a listing of state branching laws.) Although a federal law authorizing nationwide banking and branching could override such in-state branching restrictions for banks with national charters, our analysis has not assumed such a change.

- No commercial banking company in the United States, except in Hawaii, is protected from being acquired by an out-of-state bank holding company.²¹ Failed banks with more than \$500 million in assets may be acquired by any bank holding company in the country.²²
- As of December 31, 1992, 1,875 banking companies were located in the 13 states and the District of Columbia that allow unrestricted nationwide interstate banking. These banking companies, which hold more than 10 percent of the nation's banking assets, may be acquired by any other banking company in the country. Almost 3,700 more banking companies, which hold almost two-thirds of the industry's assets, are located in states with nationwide reciprocal laws into which banking companies from a majority of the United States may enter.²³ (See table 1.4)
- All but 13 states have more than 10 percent of their banking assets owned by out-of-state banking companies.
- Bank holding companies may establish nonbank subsidiaries and offices in any state that they choose.
- Assuming antitrust laws are not violated, none of the 25 largest bank holding companies in the nation is protected from interstate acquisition by at least one other banking company of comparable size.

²⁰State laws limiting in-state branching can be very diverse—some are very restrictive while others come close to allowing statewide branching.

²¹Montana enacted regional reciprocal legislation that took effect October 1, 1993.

²²States could, of course, remove the interstate restrictions they now impose without any change in federal law. They could also permit interstate branching by their state-chartered, non-Federal Reserve member banks. If all 50 states were to pass statutes permitting nationwide branching for all state-chartered, nonmember banks, 6,895 banks would be affected.

²³The total number of banking companies was calculated by adding the number of banking companies in each state. Because a banking company that has multistate operations will be identified as a banking company in each state where it is located, it will be counted more than once. For example, First Interstate, which is located in 13 states, is counted as a banking company in each of its states. When the total number of banking companies is calculated, this company would be counted 13 times.

A number of banking companies located in nationwide and nationwide reciprocal states are subsidiaries of bank holding companies headquartered in states with regional reciprocity laws. For these bank holding companies, only their banks located in states with nationwide or nationwide reciprocal interstate banking laws could be acquired by banking companies outside of the regional compact, not the entire banking company.

Table 1.4: Number of Banking Companies and the Percentage of U.S. Bank Assets by Interstate Banking and In-State Branching Laws

Interstate banking law	In-state branching laws		Total
	Statewide	Limited	
Nationwide			
Number of states	11 ^a	3	14
Number of bank companies	1,245	630	1,875
Percentage of U.S. bank assets	9%	2%	11%
Nationwide reciprocal			
Number of states	16	5	21
Number of bank companies	2,129	1,566	3,695
Percentage of U.S. bank assets	55%	10%	65%
Regional reciprocal			
Number of states	10	4	14
Number of bank companies	2,087	1,390	3,477
Percentage of U.S. bank assets	17%	6%	23%
No interstate banking			
Number of states	1	1 ^b	2
Number of bank companies	16	94	110
Percentage of U.S. bank assets	Less than 1%	Less than 1%	Less than 1%
Total			
Number of states	38	13	51
Number of bank companies	5,477	3,680	9,157
Percentage of U.S. bank assets	83%	17%	100%

Note 1: For more detailed information on the states in each category see table II.1.

Note 2: The total number of banking companies was calculated by adding the number of banking companies in each state. Because a banking company that has multistate operations will be identified as a banking company in each state, it will be counted more than once in the column and row totals.

Note 3: Data are for the period ending December 31, 1992.

^aIncludes the District of Columbia.

^bMontana enacted a regional reciprocal law that took effect October 1, 1993.

Source: Federal Reserve and call report data.

Recent changes in the banking industry's role in channeling the nation's savings to investments illustrate how competition from other financial services providers has increased as well. For the past several years, virtually all of the increase in the provision of credit in the U.S. economy has been accounted for by financial institutions that are neither banks nor other depositories. As table 1.5 shows, the increase in domestic

commercial bank assets was more than offset by a decline in assets in the thrift industry; the increase in commercial banking assets thus may represent more of a consolidation of assets within the depository sector than a real expansion of banking activity.²⁴

Table 1.5: Changes in Sources of Credit in the U.S. Economy by Type of Financial Institution for 1988-92

Dollars in billions		
Type of financial institution	Change in assets	Percentage change
Depository institutions		
U.S. commercial banks and affiliates	\$295	13%
Foreign banking offices	111	51
Savings and loans and mutual savings banks	-460	-32
Credit unions	41	28
Subtotal^a	-14	
Nondepository institutions ^b	2,135	47
Total^a	\$2,121	25%

Note: Data are for the period December 31, 1988, to June 30, 1992.

^aNumbers may not add due to rounding.

^bIncludes securities firms, life insurance companies, pension funds, investment funds, securitized asset pools, and finance companies.

Source: Federal Reserve flow of funds data.

The U.S. Banking Industry Is Consolidating

Between 1985 and 1992, the number of banks and independent banking companies in the United States fell by about 20 percent. The number of banks decreased by 2,894, from 14,344 to 11,450, even though 1,556 new banks were chartered during that time. Over the same period, the number of independent banking companies fell by 2,310 (see table 1.6). This consolidation was primarily the result of 3,489 bank mergers and 1,242 bank failures.

²⁴Banks, of course, provide services to the economy other than financing credit assets, such as transaction services, trust services, origination and securitization of loans that are sold and do not appear as bank assets, and agent services in sales of mutual funds and other products.

Table 1.6: Number of Banks and Banking Companies in the United States

Year	Banks	Banking companies
1985	14,344	11,104
1986	14,124	10,620
1987	13,665	10,257
1988	13,090	9,937
1989	12,688	9,703
1990	12,324	9,484
1991	11,906	9,248
1992	11,450	8,794

Source: Call report data.

When measured in 1992 dollars, the assets in commercial banking companies have declined by more than 7 percent since 1986, even though the U.S. economy grew about 11 percent in real terms.²⁵ (See table 1.7.) The decline in assets does not take into account the growth of off-balance sheet activity or lending that was originated by banks but that was either sold or securitized and could, therefore, exaggerate the actual decline in the role of banks in the economy.²⁶ Nevertheless, it does show that banks are financing less credit in the economy in real terms than they were just 6 years ago.²⁷

²⁵From 1986 through 1992, assets in the banking system increased by about \$583 billion (or 20 percent). This increase, however, was less than inflation of approximately 29 percent over this period. 1992 dollar comparisons measure the change net of inflation; for example, \$100 in 1992 equaled \$77.24 in 1986.

²⁶Off-balance sheet items represent commitments, contingencies, and other claims on the issuer and/or generate fees for services to be performed. Examples of such items are unused commitments for lines of credit, financial standby and performance letters of credit, foreign currency and interest rate swaps and options, mortgages sold or swapped with recourse, when-issued securities with commitments to purchase or sell, options contracts on stock index and commodities futures and forward contracts, and participation in bankers acceptances sold to others or acquired by the banking institution.

²⁷These data do not include off-balance sheet items, such as loan guarantees or unused commitments for lines of credit.

Table 1.7: Number and Assets of Banking Companies by Asset Size in 1992 Dollars

Dollars in billions

Asset size (in 1992 dollars)	1986			1992		
	Number of banking companies	Assets	Percentage of total assets	Number of banking companies	Assets	Percentage of total assets
\$10 billion or more	68	\$2,198	58.5%	56	\$2,144	61.5%
\$1 billion to \$10 billion	236	753	20.0	188	593	17.0
\$100 million to \$1 billion	2,133	486	12.9	2,053	481	13.8
Less than \$100 million	8,183	322	8.6	6,497	268	7.7
Total^a	10,620	\$3,759	100.0%	8,794	\$3,487	100.0%

Note: Data are for the periods ending December 31, 1986, and December 31, 1992.

^aNumbers may not add due to rounding.

Source: Call report data. Data for 1986 are adjusted by the consumer price index.

Changes in the banking industry have not occurred uniformly across banking companies of all sizes. As a result, the structure of the industry has changed quite dramatically. The banking companies that have been hit hardest by consolidation in terms of market share are the mid-sized ones, those with assets of between \$1 billion and \$10 billion measured in 1992 dollars. Their share of assets dropped from 20 percent in 1986 to 17 percent in 1992. Small banking companies, those with less than \$1 billion in assets, have suffered a 17-percent reduction in number—from 10,316 to 8,550—but their share of assets has remained constant at 21.5 percent.

Industry consolidation has been characterized by a greater concentration of assets among the largest banking companies in the country. The percentage of assets controlled by the largest 3, 10, 20, and 50 banking companies has increased (see table 1.8). The 50 largest banking companies controlled 53 percent of national banking assets in 1986; they increased this share to 60 percent by 1992. Even these increases underestimate the relative importance of larger banking companies because off-balance sheet obligations, which are held predominantly by larger institutions and have been increasing in significance, are not included in bank asset calculations.

Table 1.8: The Concentration Ratios of the 3, 10, 20, and 50 Largest Banking Companies in the United States

Concentration ratio of the largest banking companies	1986	1992
3	12.8%	14.4%
10	26.3	29.4
20	36.4	41.5
50	53.0	59.5

Note: Data are for the periods ending December 31, 1986, and December 31, 1992.

Source: Call report data.

Objectives, Scope, and Methodology

Our principal objective in this congressionally requested study was to analyze the potential impact of interstate banking and branching on the banking industry and the U.S. economy. To simplify the analysis, we assumed that federal legislation liberalizing interstate banking and branching would completely remove interstate banking and branching restrictions on national banks. We further assumed that states would allow state-chartered banks to follow suit, thus maintaining the value of the state charter. If states are given the option of modifying federal law—for example, by opting out—the effects of a change in federal law would obviously be modified.²⁸ Finally, we assumed that states will retain their current authority over consumer protection issues.²⁹

In line with the request, we focused on the following objectives:

- how changing federal laws on interstate banking and branching might affect the structure of the banking industry examined from the perspective of a bank holding company to the extent data limitations permitted;
- the implications of interstate banking and branching on the safety and soundness of the banking industry, BIF, and the economy; and
- the risks associated with relaxing interstate banking and branching laws and ways to minimize such risks.

We do not reach definitive conclusions about the impact of removing existing interstate banking and branching restrictions in this report. The outcome of removing these restrictions will depend not only on such

²⁸During the consideration of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), amendments were adopted by both the House and Senate to allow interstate branching while giving states the opportunity to opt out. If states chose to opt out, out-of-state banks would have been prohibited from branching into the states, and in-state banks would have been prohibited from branching out. The amendments were not included in the final version of FDICIA.

²⁹Such a provision was also included in the amendments to FDICIA as noted in footnote 26.

elements as managerial decisions but also on the extent to which current laws and regulations have prevented banking organizations from moving across state lines or altered the form such movement has taken. We do not know the extent of these constraints. A significant amount of interstate banking is already occurring, and funds flow across state lines even between banking companies that do not have interstate subsidiaries. Data limitations prevented us from knowing where loans are made or to whom, and the same was true for deposit gathering. Nevertheless, whenever possible, we attempt to highlight effects that would be primarily due to a federal law permitting nationwide banking and branching.

Information Sources

The analysis in this report draws on numerous sources of information that fall into five broad categories: previously published written materials, interviews, regulatory agency files, analysis of quantitative data, and another of our reports that was undertaken concurrently on the impact of interstate banking and in-state branching in the states of California, Washington, and Arizona.

Written Materials

Many of the issues associated with interstate banking and branching that we discuss have been the subject of intensive economic research. Topics addressed in this research include geographic diversification, economies of scale and scope, efficiency improvements, cost savings associated with bank mergers, the relationship of concentration and pricing, the relevance of local markets in analyzing antitrust issues, and the ability of small banks to compete with larger banks. While a complete review of all such research was not possible, we reviewed the studies that experts suggested were the most significant and relevant to the topics we were discussing.

Additional literature that we reviewed included monographs; articles; testimonies; and papers on the history of interstate banking and branching restrictions and their effect, the history of in-state branching and its effect, the evolution of interstate banking, changes in the U.S. banking structure, the potential costs and benefits of interstate banking and branching, the evolution of antitrust analysis, the bank merger and acquisition process, the history of financial flows in the United States, the changing role of banks in the U.S. financial system, the role of banks in community investment, and the evolution of community development banks.

Finally, we reviewed relevant laws and legislation and written background and descriptive materials that related to those laws. Relevant laws included the Garn-St Germain Depository Institutions Act of 1982, the

Competitive Equality Banking Act of 1987, the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), FDICIA, the Bank Holding Company Act of 1956, the McFadden Act of 1927, the Banking Act of 1933, the Community Reinvestment Act of 1977, and drafts of proposed interstate banking and branching provisions.

The Views of Market
Participants, Regulators, and
Experts

Many individuals, interest groups, and regulatory agencies have an interest in the outcome of the debate on interstate banking and branching or have studied the issues involved. To the extent time permitted, we met with representatives from the major interest groups, industry associations, and individual banks and businesses that have a stake in changes in geographic restrictions. We obtained their views on both the positive and negative aspects of interstate banking and branching. We discussed issues associated with geographic expansion and industry consolidation with federal bank and thrift regulators, some state bank regulators, Department of Justice officials, some state attorneys general, and officials from other federal and state agencies such as the Small Business Administration, the Export-Import Bank, and state development agencies.

We also obtained the views of individuals and organizations knowledgeable about the performance of the banking industry, banking industry consolidation, antitrust regulation, and the past and potential effects of interstate banking and branching. These included banking industry analysts and consultants, attorneys, investment bankers, rating agency staff, academics, and small business and international trade experts. In the process of this study, we conducted at least 122 interviews to discuss interstate banking and branching and associated issues.³⁰ We also surveyed officials from each of the 12 district Federal Reserve Banks for their views on the supervision of bank holding companies and the likely impact of interstate branching on bank holding company supervision.

Regulatory Agency Files

To better understand bank regulatory and supervisory processes germane to our study, we reviewed relevant agency policy manuals, 12 bank merger files at the Federal Reserve, and 8 merger files at the Justice Department. We judgmentally selected mergers that we believed would enhance our understanding of the criteria and processes bank regulators and the Justice Department used to approve, deny, or challenge bank merger applications. The files we chose to review included several of the largest recent banking company mergers and some banking company mergers

³⁰A list of organizations that we interviewed is included in appendix VI.

that exceeded the Justice Department antitrust guidelines in some markets.

Quantitative Data

A large portion of our work encompassed the collection and analysis of numerous sources of quantitative data. These sources included raw data that we used in our analysis of specific issues as well as surveys and other data compiled by outside sources. Our analysis focused on the period 1986 through 1992. While there was some interstate banking before 1986, we were limited by data availability to this period. We defined the United States as the 50 states and the District of Columbia.

We used data from bank call reports, bank holding company reports, and bank summary of deposit reports—which provide information on bank branches and deposits in those branches—to compile statistics on the banking industry. We used Federal Reserve flow of funds data to compare the role of banking companies with that of other financial services providers. Employment data from the Bureau of Labor Statistics provided a measure of economic growth in various regions of the country.

Because we relied on bank call reports for most of our data, in our analysis, we used the balance sheets and income statements of banks rather than bank holding companies. The data, however, were consolidated and reported by banking company because we believe that banking companies are more representative of the number of banks that compete against each other within banking markets. A banking company is the sum of all banks owned by a single entity. For example, First Interstate, which had separately chartered banks in 13 states, is counted in our data as one banking company. Similarly, one-bank holding companies and independent banks are each counted as one banking company.

Throughout the report, we designated as out-of-state those banks that were part of interstate bank holding companies outside of the headquarters state and those banks with foreign ownership. There are a total of 242 out-of-state banking companies. References to multistate banking companies include those banks that are part of an interstate bank holding company, including several foreign banking companies that own banks across state lines. In 1992 there were 190 banking companies with multistate operations.

To measure the impact of interstate banking on safety and soundness and the availability of banking services, we analyzed differences in the behavior and performance of banks owned by out-of-state organizations

and those owned and operated locally. This methodology is explained in detail in chapter 6.

We also used information from surveys conducted by the Federal Reserve, the Small Business Administration, the National Federation of Independent Businesses, Greenwich and Associates, Grant Thornton, and Arthur Andersen and Company. Finally, whenever possible, we reviewed quantitative data used by others to support their claims of costs or benefits arising from interstate banking and branching. We did not independently duplicate the methodology used in these studies or evaluate the accuracy of the data, but we assessed the reasonableness of the studies and the assumptions that were made.

Data limitations significantly restrict the analysis of differences in the lending patterns of community banks versus those of interstate banks. Loan and deposit data in bank call reports do not reveal the geographical sources of a bank's deposits or the geographical destinations of the money that it lends. For example,

- A community bank may lend significant amounts of locally gathered deposits to large banks outside of its normal business area. For many years, small banks have typically done such lending through their sales of federal funds to large banks.
- A community bank can bring funds to its local market by issuing participations of large loans (overlimit loans) to outside banks. This, too, is a common practice.
- Local subsidiaries of bank holding companies can sell shares of commercial loans syndicated by affiliated banks in other markets, thus deploying locally raised funds elsewhere.
- Conversely, local subsidiaries can sell shares of local loans to affiliates, which effectively increases the money local subsidiaries have to satisfy local credit needs.
- Local subsidiaries can be funded with deposits from their parent holding company for loans or for liquidity purposes.

Therefore, it is essential to recognize that in most of the studies we have referred to or have undertaken ourselves in connection with this report, the analyses have been limited by incomplete information.

Our Concurrent Study of
Western States

Our report also draws on a separate, concurrent study we have undertaken of interstate banking and branching. That study focuses on the impact that interstate banking and in-state branching in California,

Washington, and Arizona have had on the structure of the banking industry, small businesses, and low-to-moderate income borrowers in those states.

We did our work between November 1991 and March 1993 in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the Federal Reserve, OCC, FDIC, and the Department of the Treasury. FDIC and the Department of the Treasury provided brief written comments, which appear in appendixes VII and VIII respectively. The Federal Reserve and OCC did not provide us with written comments, but in discussing the report with us, they made technical comments, which we incorporated where appropriate.

FDIC indicated that as a general matter it supports the relaxation of geographic and product restraints on banks provided that the states continue to play a role in the transition. The agency pointed out that BIF has absorbed major losses in rescuing banking organizations with assets concentrated in a few industries or in a limited geographic area. FDIC stated that these banking organizations may have been better able to withstand the problems in their local and regional markets if they had been more geographically diversified. We address this issue in chapter 4 of this report.

The Department of the Treasury stated that it had no formal comments but found the report to be an impressive and thoughtful survey of the issues and evidence.

Legal, Market, and Regulatory Factors That Will Affect the Response to a Federal Nationwide Banking and Branching Law

Chapter Summary

Topic	Principal Findings
<p>This chapter examines the primary factors that will help determine the impact a federal law permitting nationwide banking and branching could have on the structure of the banking industry.</p>	<p>Although a large amount of interstate banking has already taken place, barriers to interstate banking and branching remain. A wide range of reactions to removing these barriers is possible. The response to a federal law permitting nationwide banking and branching would depend on the following:</p> <ul style="list-style-type: none"> • the extent to which current laws have prevented interstate expansion from otherwise occurring, • states' interstate banking statutes and the extent to which they would be changed by a federal law, • the decisions made by bank owners and managers and by other market participants, and • bank regulation.

The magnitude of interstate banking and branching under a nationwide banking and branching law will be affected by a number of factors, many of which have contributed to the trend toward banking industry consolidation to date. A federal law authorizing nationwide banking and branching will increase the opportunities for and enhance the means of interstate expansion significantly. Whether and how banking companies will take advantage of these opportunities will be determined by the extent to which they are currently constrained from interstate expansion and by market and regulatory factors.

The precise effect of nationwide banking and branching is not predictable since that will ultimately depend on how individual institutions react to the motivating factors of, as well as constraints imposed by, the market. A broad spectrum of reactions is possible, ranging from little additional consolidation if, for example, mergers become difficult to finance, to a significant increase in the rate of consolidation if a large number of banking companies believe that they must grow in order to compete.

The Legal Impact of Changing Federal Interstate Banking and Branching Laws

Although interstate banking will continue to occur because of state laws that permit out-of-state entry, barriers to interstate expansion—affecting both the means and extent of expansion—remain and could be eliminated by a federal nationwide banking and branching law. A federal law permitting nationwide banking and branching would allow banks

headquartered anywhere in the United States to enter any other state—through either bank subsidiaries or branches. This would occur either by acquisition or by establishing new, or de novo, offices.¹ No bank in the United States would be protected from acquisition by any other bank, and no community or state could block the entry of out-of-state banking companies.

The legal changes obviously would be greatest in those states that now restrict interstate banking and branching the most and, perhaps less obviously, for the banking companies located in those states. The legal ground rules of nationwide banking and branching legislation could, of course, be modified by permitting state-chartered banking companies to opt out—thus protecting them from acquisition by out-of-state bank holding companies but also restricting them from expanding into other states—or by continuing restrictions on de novo banking or acquisitions of newly chartered banking companies. Our analysis assumes that such restrictions would not be part of a federal law.

Interstate Branching

Permitting nationwide branching would have a significant impact on the way in which banking companies are allowed to expand across state lines. It would reverse the almost complete prohibition on interstate branching currently imposed on banking companies by allowing any bank to establish interstate branches—by converting existing interstate subsidiaries into branches, by acquiring branches in another state, or by branching de novo across state lines. Because almost no interstate branching has been allowed to date, the legal impact of permitting nationwide branching would be similar in all states and for all banking companies.

Interstate Banking

By early 1993, all but two states—Montana and Hawaii—had implemented legislation permitting some degree of interstate entry.² A federal law authorizing nationwide banking could nevertheless have a measurable impact on the ability to bank interstate by eliminating the numerous restrictions that remain on the manner and extent of interstate expansion.

¹We assume that such legislation would remove all interstate banking and branching restrictions on national banks and that states would allow state-chartered banks to follow suit in order to maintain the value of the state charter.

²Montana enacted a regional reciprocal banking law that took effect October 1, 1993.

Impact on Ability to Enter
States

The degree to which a nationwide banking law would change the legal status quo in individual states will depend on the states' current interstate banking statutes (see table 1.4). A federal law permitting nationwide banking would not affect entry into the 13 states and the District of Columbia that already permit nationwide banking—states with 11 percent of the industry's assets. Montana and Hawaii would be affected the most because they have not allowed interstate banking.³ However, these two states contain less than 1 percent of the country's banking assets.

A nationwide banking law would open the 14 states with regional reciprocal laws, which contain 23 percent of the nation's banking assets, to entry from banking companies headquartered in all states that are currently not part of the regional compacts. The legal impact would vary by state, depending on each state's regional reciprocal law—that is, how many states it includes in its region. The number of states included in each of the 14 states' regional definitions ranges from 6 to 17. Banking companies headquartered in states that are not included in the regional definitions are blocked from entering.

States with nationwide reciprocal laws—the 21 states in which 65 percent of the industry's assets are located—would also face increased entry under nationwide banking. Again, the impact of the law would vary by state, depending on the number of states that currently do not grant it reciprocity. Of the states with nationwide reciprocal laws, Kentucky is granted reciprocity by the most other states, 43, and would consequently be affected the least by a nationwide banking law. States like Arizona, Connecticut, California, New York, or Alaska, which are not included in any regional compacts, are currently granted reciprocity by the fewest states, 33 state and the District of Columbia.

Depending on how the federal law is written, it could also override state laws that restrict the manner and extent of interstate entry. Such restrictions include the following:

- The chartering of new banks by out-of-state banking companies is limited. All but 17 states restrict entry to the acquisition of existing banks.
- Acquisition is limited to banks that have been in existence for a minimum number of years—generally 2 to 5 but up to 10.

³It should be noted that Hawaii allows the acquisition of banks headquartered in American Samoa, Guam, the Marshall Islands, Micronesia, the Northern Marianas, and Palau.

- The percentage of the state's deposits that can be held by any single out-of-state bank holding company is limited. Limits range from 10 percent to 30 percent and have been enacted in 17 states.

Impact on Banking Companies Expanding Interstate

A nationwide banking law would also simplify interstate banking for banking companies wanting to expand interstate. Banking companies have been prohibited from entry into Montana and Hawaii as well as into regional reciprocal states unless they are headquartered in states that are included in regional compacts. Furthermore, the Southeast regional compact laws limit the banking companies headquartered in the Southeast from having out-of-state ownership of more than 20 percent of their total assets in states not belonging to the compact. If banking companies headquartered in the Southeast region exceed that percentage, they are no longer considered Southeast regional banks and must divest their banking assets in the states with Southeast regional reciprocal laws.⁴ Thirteen banking companies that have more than \$10 billion in assets—holding more than 12 percent of the banking industry's assets—are headquartered in regional reciprocal states.

Market Factors That Will Determine the Response to Nationwide Banking and Branching

Removing federal restrictions on interstate banking and branching would create a legal framework permitting banking companies to enter markets currently prohibited to them. Yet, just because banking companies may enter a state does not mean that they will. The response to additional interstate banking opportunities will depend in large measure on the decisions made by bank owners and managers and by other market participants. It will also depend on the extent to which the banking companies want to expand but are currently prevented from doing so.

Bank Strategies

Over the past several years, the banking industry has changed significantly as banking companies have adjusted to increased competition. Some banking companies have adjusted their services or become more focused on certain product lines. Others have cut their costs in order to offer more competitive pricing without reducing profits significantly. Still others have acquired some of their competitors in efforts to gain market share to better position themselves for meeting increased competition or to make

⁴For example, NationsBank is headquartered in North Carolina, a state belonging to the Southeast regional compact. North Carolina has defined this region as including 12 states plus the District of Columbia. Nine of these states have regional reciprocal laws that require NationsBank to maintain 80 percent of its deposits in the region in order to qualify for reciprocity. If NationsBank were to exceed the 20-percent limit for out-of-region ownership, it would be forced to divest its bank holdings in these nine states or reduce its out-of-region ownership.

themselves too profitable to be acquired by other institutions.⁵ Other competitive factors that have driven mergers have included seeking to serve whole market areas—such as New York, Philadelphia, and Washington, D.C.—that once were divided by state borders; taking advantage of economic growth in other states; diversifying geographically; and taking advantage of market efficiencies.⁶

Most market participants have indicated to us that management decisions that have driven consolidation and interstate banking in the past would continue under nationwide banking. These reactions to additional opportunities for interstate banking are difficult to predict because they involve expectations that each banking company may have regarding the conditions of the market in which the bank is currently operating, markets the bank might wish to enter, and the future role of banks in the economy.

Acquiring banks have generally targeted initial acquisitions that enable them to either become one of the largest three or four providers of banking services in a market or to acquire at least a 10-percent market share. This, of course, does not preclude them from acquiring smaller institutions once they have established a significant market share. Work we have done in Washington and Arizona shows that acquisitions of smaller banks are not uncommon.

Enhanced Efficiency and Cost Savings

In an industry that is shrinking compared with other financial services providers, acquiring banking companies may emphasize cost savings and efficiency improvements from mergers in an effort to gain market share and survive.⁷ Cost savings and efficiency improvements may be achieved through economies of scale—where average cost declines as bank size increases—or improvements in managerial efficiency.

A number of banking analysts have concluded that many banks would benefit from being larger and forecast cost savings from mergers. Economic studies focusing on the banking industry, however, generally conclude that there is no reason to believe that once banks have reached

⁵By expanding in this way, the local bank would become a larger entity and would be more expensive for somebody to acquire. On the other hand, such expansion may make the franchise more valuable and hence more attractive to a relatively larger bank that wants to enter the local market.

⁶Other factors mentioned in our interviews that have affected the choice of acquisition target in interstate expansion have included perceived cost savings associated with mergers, the opportunity to fill voids in product lines, branch networks, deposit franchises, the compatibility of corporate cultures, and the opportunity of bank management to increase its compensation in line with increased scales of activities.

⁷A more in-depth discussion of these issues is in appendix V.

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\$100 million in assets that further increases in size automatically result in additional savings. They doubt that economies of scale exist for larger banks.

Many market participants debate these findings, emphasizing that if banking companies were able to focus on a relatively few activities, cost savings would increase with bank size. There seems to be a consensus among bankers and industry analysts that there are cost benefits associated with size in several market or product lines—such as check clearing, centralized customer service, credit card lending, home mortgage lending and processing, securities investment and trading, and interest rate swaps and other derivative products. It is possible that these savings existed in the banking companies analyzed in past economic studies but that higher costs elsewhere in the organizations offset the savings. Whether or not these savings are achievable in the long run, expected cost savings have been major factors in a number of the larger mergers in recent years and are likely to continue to be important in future mergers.

Apart from the question of economies of scale, bank analysts believe that many banks could significantly improve their efficiency if they were acquired by more efficient banks. (See further discussion of economies of scale and evidence regarding cost savings in ch. 4.) Analysts have estimated that as a group, banks with more than \$1 billion in assets could save from \$12 billion to \$15 billion in noninterest expenses per year if they adopted the practices of the industry's most efficient banks. This represents a potential savings of about 10 percent of the industry's noninterest expenses, which were about \$131 billion in 1992.

Although these savings could theoretically be accomplished by the existing bank owners, industry analysts often assume that they would be much more likely to be realized through the merger process.⁸ In such a process, acquiring banks would reduce excess or redundant costs in the banks they take over. Eventually, after enough mergers, the overall efficiency of the industry would improve. One analyst estimated that slightly more than half of the savings could be achieved in mergers among banking companies that have more than \$10 billion in assets and that most

⁸Some of the savings attributed to nationwide banking may be achieved under the current interstate banking structure. For example, several multistate banking organizations have been able to consolidate operations centers, reduce costs by assigning officers to multiple banks, and manage risk centrally. Processes can also be centralized so that even though deposits are booked at branches and loan applications are taken there, decisions regarding loans beyond certain size limits can be made at regional centers. At least one banking company has told us that the incremental cost savings resulting from the elimination of duplication currently required by geographic restrictions may not be that significant.

of the rest would occur in consolidation of institutions that are between \$1 billion and \$10 billion in size. Liberalized interstate banking would increase the opportunities for such consolidation to take place.

Financial Markets

Particularly in larger acquisitions, market capitalization⁹ is a key factor in determining the affordability of the merger transactions.¹⁰ If market capital is weak, banking companies are less able to afford acquisitions and, consequently, cannot take advantage of opportunities to expand.

The market generally determines whether bank acquisitions are affordable. If financial market participants do not approve of a merger or do not like the strategic plan being followed by a bank that wants to expand, they may provide funds to finance the merger only at a high price, making the merger financially unfeasible. Market participants can also sell the shares of an acquiring bank, thereby driving down its price, again making the acquisitions more expensive and providing a powerful incentive for the bank's management to change policies.¹¹

The success certain superregional bank holding companies have had in expanding their interstate banking operations illustrates the importance of market capital. These holding companies are valued more highly by the market, making it easier for them to expand than for banking companies that may be larger in asset size or in book value of capital but weaker in market value (see table 2.1). A more in-depth discussion of these issues can be found in appendix V.

⁹Market capitalization is the price per share of stock multiplied by the number of shares outstanding.

¹⁰Although establishing new branches may often be the least costly way to expand into a market, we have been told that the principal way most banks would take advantage of nationwide banking laws is through the acquisition of existing banks. This gives the acquiring bank the opportunity to obtain a significant market share, something that would take a long time to build through de novo branching or banking. This may not be possible in a market, however.

¹¹A key factor that affects stock price is earnings dilution. Issuing new stock to undertake a merger financed by an exchange of stock increases the number of shares over which earnings must be spread, thereby diluting earnings. Generally speaking, market participants react negatively to acquisitions that will reduce expected earnings per share by more than a slight amount.

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Table 2.1: Capitalization and Assets of the 20 Largest Bank Holding Companies

Dollars in millions

Bank holding company	Market capital^a	Rank	Book capital^b	Rank	Assets^c	Rank
BankAmerica Corp.	\$16,149	1	\$12,151	1	\$180,646	2
NationsBank	12,882	2	7,371	4	118,059	4
J.P. Morgan & Co. Inc.	12,556	3	6,389	5	102,941	5
Banc One Corp.	11,043	4	4,198	7	61,417	8
Chemical Banking Corp.	9,507	5	7,788	3	139,655	3
Citicorp	8,134	6	7,931	2	213,701	1
PNC Financial Corp.	6,352	7	3,622	8	51,380	10
Norwest Corp.	6,014	8	2,713	14	44,557	15
First Union Corp.	5,847	9	3,397	9	51,327	11
Wachovia Corp.	5,829	10	2,689	15	33,367	21
Bankers Trust New York	5,692	11	3,288	10	72,448	7
SunTrust Banks	5,476	12	2,646	16	36,649	20
NBD BankCorp.	5,219	13	2,456	19	40,937	16
Chase Manhattan Corp.	4,380	14	4,890	6	95,862	6
Bank of New York Co.	4,331	15	3,029	11	40,909	17
Wells Fargo & Co.	4,093	16	3,014	12	52,537	9
Fleet Financial Group, Inc.	4,030	17	2,343	20	46,939	14
National City Corp.	3,896	18	2,233	21	28,963	25
Society Corp.	3,730	19	1,739	28	24,978	29
Comerica	3,648	20	1,920	25	26,587	26

^aMarket capital is the number of shares outstanding multiplied by the stock price.

^bMeasured as common equity. Data are as of June 30, 1992.

^cData are for the period ending December 31, 1992.

Source: American Banker and Federal Reserve data.

How the Role of Bank Regulation Will Affect a Nationwide Banking and Branching Law

Because banking is a regulated industry—with the majority of its assets financed by insured deposits—regulation will also play a role in determining the reaction to a federal nationwide banking and branching law. Regulation is intended to maintain the safety and soundness of banks, thereby protecting the deposit insurance system from loss and ensuring the availability of bank credit and services. Bank regulation also reflects the special role that depository institutions play in the economy; demand

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deposits, for example, are a major component of the nation's money supply, and banks have traditionally been the major source of credit in local markets.

Safety and soundness regulations focus on bank risk-taking and management. Their purpose is to protect the public by reducing the possibility of systemic and individual bank failures and their cost to the deposit insurance system. Safety and soundness regulations include capital adequacy requirements, bank examinations, and supervisory controls over problem banking companies. Recent improvements to safety and soundness regulations were included in FDICIA. This act was adopted in response to the depletion of BIF brought about by high deposit insurance losses. In 1991, BIF lost about \$11 billion and ended that year with the first deficit in its history. The regulatory and supervisory reforms contained in FDICIA were designed to protect healthy banks that have to pay deposit insurance premiums, as well as the taxpayers, from rising deposit insurance costs.

As a result of BIF's financial problems, improvements to safety and soundness regulation were included in FDICIA. FDICIA's key provisions are (1) prompt corrective action to close institutions before their capital runs out; (2) management and auditing reforms that highlight private sector responsibility for protecting the taxpayers from losses; (3) accounting reforms to provide accurate information to management, regulators, and the public; (4) annual, on-site examinations for most banks to detect problems on a more timely basis; and (5) changes in the way banks are closed so that uninsured depositors and general creditors will be more likely to share in the losses if a bank fails.

Antitrust regulation, CRA, which requires banks to support the needs of the communities in which they are located,¹² and regulation of such aspects of banking as the chartering of new banks are designed to address problems with the availability and pricing of banking services. While bank regulation, in general, is fairly subjective, the regulation of banking services and pricing, broadly described as serving the convenience and needs of the community, in particular requires even more judgment. For example, no standard exists for the number of banks required to best serve the economy. It is also difficult to determine exactly where free markets are inadequate to serve the needs of bank customers and the economy. Furthermore, problems with the efficacy of such regulation are

¹²For an explanation of CRA, see chapter 6.

generally not apparent until bank customers have suffered a certain amount of hardship—be it in terms of pricing or service availability.

The bank approval process must weigh the trade-offs between the goals of safety and soundness regulations and those of convenience and needs. It is through this process that federal bank regulators will influence banking industry consolidation and the impact of interstate banking and branching since they must approve every application by a bank to branch or to charter or acquire a bank in state or in another state. Most interstate banking activity has been the result of bank mergers and acquisitions because a majority of states prohibit the chartering of new banks by out-of-state bank holding companies.

For a bank or bank holding company to merge with another bank or bank holding company, the Bank Merger Act or the Bank Holding Company Act¹³ require it to obtain the approval of a federal regulator. The Bank Merger and the Bank Holding Company acts require the relevant agencies to consider several general criteria in deciding the outcome of a merger application. These criteria include the financial and managerial resources and future prospects of the company or companies and banks concerned, community needs, and the effect of the merger on competition. Because of the potential influence that regulators can have on market decisions, this report looks carefully at what regulators could do to minimize any adverse effects that might be associated with changing federal interstate banking and branching laws.

Conclusions

The market and regulatory factors that have contributed to industry consolidation to date are likely to remain influential, whether or not federal interstate statutes are changed. These factors will help determine to what extent banking companies will take advantage of the additional interstate opportunities provided by the authority to bank and branch nationwide.

It is likely that removing interstate banking and branching restrictions will promote consolidation among banking companies both between and within states. However, the availability of market capital in financing mergers may serve to restrict the number of interstate acquisitions. On balance, the effect of nationwide banking and branching and how and

¹³Acquisitions refer to transactions in which the target bank or bank holding company remains a separate entity after the transaction. Mergers occur when the entity becomes part of its acquiror and disappears after the transaction. In this report, the term merger will be used to describe both types of transactions unless otherwise stated.

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where banking companies will choose to expand are impossible to predict precisely. As we discuss in the following chapter, a wide range of outcomes is possible depending on the reaction of individual banking companies to the factors motivating, as well as constraining, interstate acquisitions.

A Nationwide Banking and Branching Law Could Affect the Structure of the Industry

Chapter Summary

Topic	Principal Findings
<p>This chapter uses recent industry experience with consolidation and interstate banking as a guide to examine how a federal law permitting nationwide banking and branching could change the structure of the banking industry.</p>	<p>Although we cannot predict with certainty what would happen if restrictions on interstate banking and branching laws were removed, it is likely that such action would lead to</p> <ul style="list-style-type: none"> • a significant increase in the size of some of the largest banking companies in the United States, • an increase in the share of the industry's assets held by the largest banking companies, and • an increase in the percentage of the U.S. banking assets owned by interstate banking companies. <p>However, increases in the size of the nation's largest banks will not necessarily result in a reduced role for banks with less than \$1 billion in assets or in higher state or local market concentration levels. In the past several years, smaller banks have maintained their market share nationally and increased it in most of those states with a high degree of out-of-state ownership and high state concentration levels. While concentration levels in certain local urban and rural markets have changed over the past decade, average concentration levels have not changed despite industry consolidation.</p>

Increased competition resulting from removing federal restrictions on interstate banking and branching will likely add to the consolidation trend in banking. It is not possible to determine the precise effects of liberalizing interstate banking and branching laws because so much depends on the somewhat unpredictable decisions made by market participants and regulators. However, we believe that it is reasonable to expect the following largely on the basis of how consolidation has affected the banking industry to date:

- Nationwide banking and branching will encourage the growth of larger, more geographically diversified banking companies. Some of these may establish a nationwide presence, while others may focus on particular regions. In any case, national and regional concentration levels are likely to increase.¹
- It is more difficult to generalize about changes in concentration at the state and local levels, given the unique economic and banking structure characteristics in individual states and markets. On the basis of past experience, concentration levels may rise in some states or markets and fall in others. In general, however, local market and state concentration

¹As we discuss in more detail in chapter 7, issues of concentration are important as they affect market power and the ability to dictate pricing by individual banks or a group of banks in banking markets.

levels would remain more stable than those at the regional or national levels.

- Although the number of banking companies with less than \$1 billion in assets is likely to continue falling, thousands of these banks would survive, and their share of total banking assets may not suffer as a result of consolidation.

In general, economic conditions, the existing bank structure and banking laws, and other factors affecting competition likely will be more influential than a change in interstate banking laws in determining how the industry's structure will evolve.

Interstate Branching

A federal law authorizing nationwide interstate branching by all banks would be likely to have its most immediate, visible effect on the total number of banks. If all 190 interstate bank holding companies converted their out-of-state bank subsidiaries into branch networks, the number of banks in the United States would decrease by 700, or about 6 percent. Although the number of banks would decrease as a result of such branch conversions, the number of banking companies and bank offices would remain unchanged.² Even under interstate branching, not all banking companies would choose to convert their subsidiary banks to branches; although in states that have changed their in-state branching laws, many have chosen to do so. Moreover, in states that impose branching restrictions, banking companies' abilities to convert subsidiary banks into branches may be limited.

Beyond a likely decline in the number of banks in the United States, the immediate effects of interstate branching would probably be limited. We have found in discussions with bank regulators and banking companies that most subsidiary banks are already centrally managed; their primary policies are determined by the bank holding company. As a result, the practical effect of the ability to consolidate subsidiaries into branches will not be as great, in many cases, as the potential effect on the number of banks. It is unlikely that the consolidation of bank subsidiaries into

²A banking company refers to one or many banks owned by a single entity. Thus, if a banking company owns a number of separately chartered banks, the number of banking companies would be one, while the number of banks would be greater than one. In order to aggregate banking assets by state, region, or nationally, we grouped banks that are owned by a single entity together under that entity's identification and counted them as one banking company. Banking companies represented on a state or regional basis are the sum of the assets of all of the banks owned by one entity within the state or region. The state or regional banking assets of the banking company will be less than the banking assets of the entire company if the company owns banks in other states or regions.

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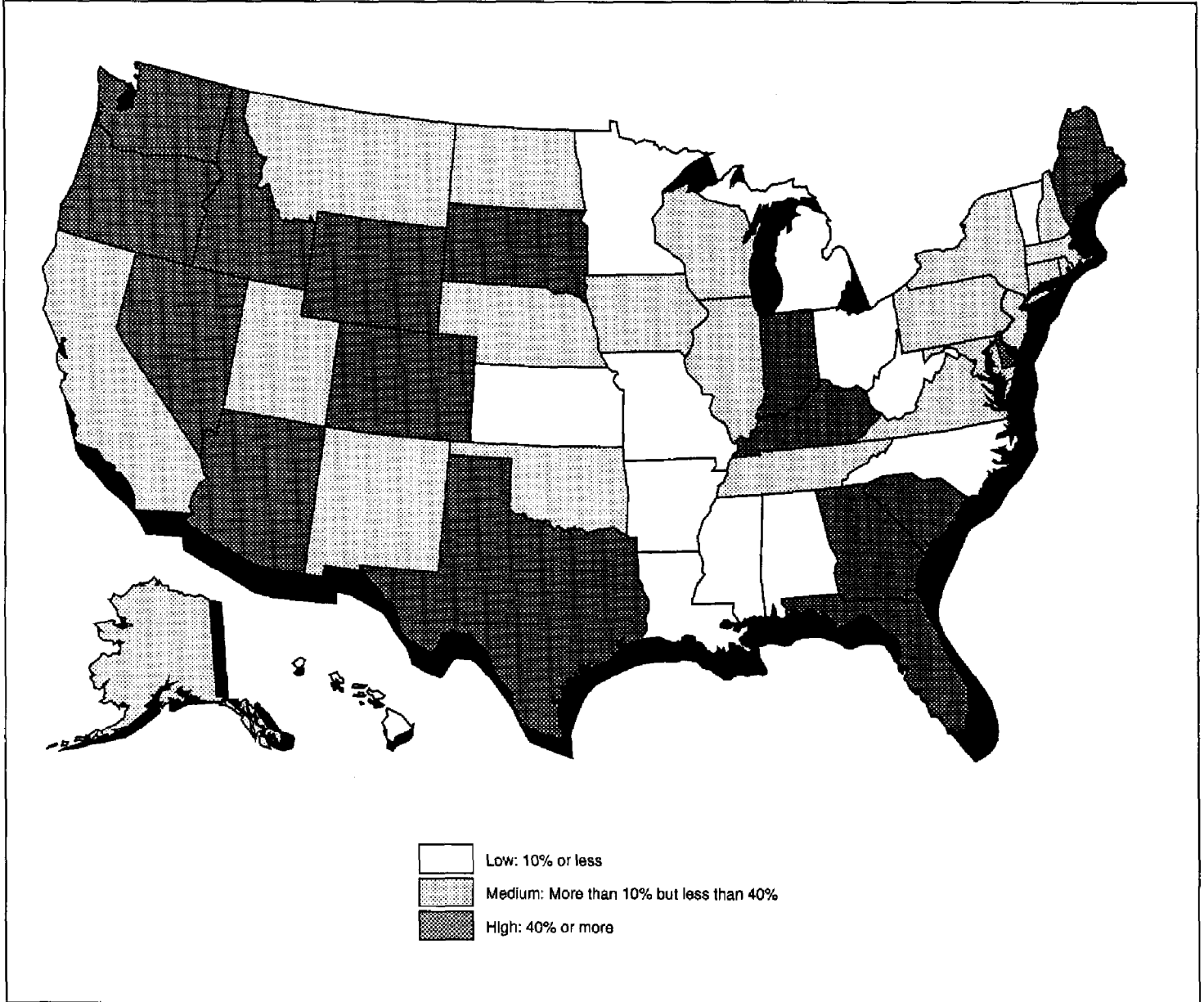
branches would result in significant policy changes in the banking company.

Interstate banking has already resulted in changes in bank ownership in many states. At the present time, 16 states and the District of Columbia have more than 40 percent of their banking assets controlled by banking companies headquartered out of state. In three states (Maine, Nevada, and Washington), the percentage is 70 or more. (See fig. 3.1.) A conversion of banks to branches under interstate branching would not change this, although public perceptions about out-of-state ownership may change.

The conversion of interstate bank subsidiaries into branch networks may also have a significant impact on the distribution of bank charters, since many of the larger holding companies have a combination of state and national charters. If such a holding company were to consolidate its subsidiaries into one national bank, for example, the assets under OCC regulation would increase while those under FDIC or Federal Reserve regulation would decrease.

Interstate branching could also change the structure of the banking industry if banking companies found expansion through branches more attractive than expansion through bank subsidiaries. This could be the case if, as is commonly believed, branches are less costly to establish de novo than bank subsidiaries.

Figure 3.1: Percentage of Assets in Each State Controlled by Out-of-State Banking Companies as of December 31, 1992



Note: Out-of-state ownership includes ownership by foreign banking companies.

Source: Call report data.

Large Banking Companies

In the past several years, there has been considerable change among the nation's largest banking companies—those with \$10 billion or more in assets. While the share of industry assets held by these banking companies increased, the asset share of those large banking companies active in interstate banking increased more. As a result, large interstate banking companies now account for a greater share of the largest banking companies' total assets than they did in 1986. We believe it is reasonable to assume that interstate banking and branching would continue to encourage the growth of the larger, interstate banking companies.

Large Banking Companies Have Experienced Significant Change

As we noted in chapter 1, banking industry assets decreased by 7 percent between 1986 and 1992, when measured in 1992 dollars. At the same time, the assets held by banking companies with assets of \$10 billion or more (also measured in 1992 dollars) dropped by only about 2 percent, so that this group's share of the industry's assets actually increased.³ Although the nation's largest banking companies show relative overall stability in assets and market share, individual banking companies within the category have experienced a great deal of change, as the following examples illustrate:

- Between 1986 and 1992, the number of banking companies with assets greater than \$10 billion fell by almost one-fifth—from 68 to 56.⁴
- Nineteen of these 68 banking companies either failed or were acquired by the end of 1992. In 1986, these 19 banking companies held 23 percent of total large banking company assets.
- Assets in 12 more of the 68 large banking companies fell by \$170 billion by 1992. Three more fell out of the more than \$10 billion in assets category.
- By 1992, 10 additional large banking companies, representing 6 percent of the assets in large banking companies, entered the category of \$10 billion or more in assets.

Interstate Banking Contributed Significantly to the Change That Occurred Among Large Banking Companies

Interstate banking has played a significant role in the consolidation of and changes in the nation's largest banking companies. For example, between 1986 and 1992 the assets held by large U.S.-owned banking companies in out-of-state banking subsidiaries increased by approximately 140 percent, or \$351 billion measured in 1992 dollars. As we mentioned earlier, the total assets of large banking companies (measured in 1992 dollars) decreased during the same period. As a result, about 29 percent of the assets of all

³The market share increased from 58.5 percent in 1986 to 61.6 percent in 1992 (see table 1.7).

⁴As we noted earlier, these comparisons are being made in 1992 dollars. In 1986 dollars, there were 51 banking companies with more than \$10 billion in assets in 1986.

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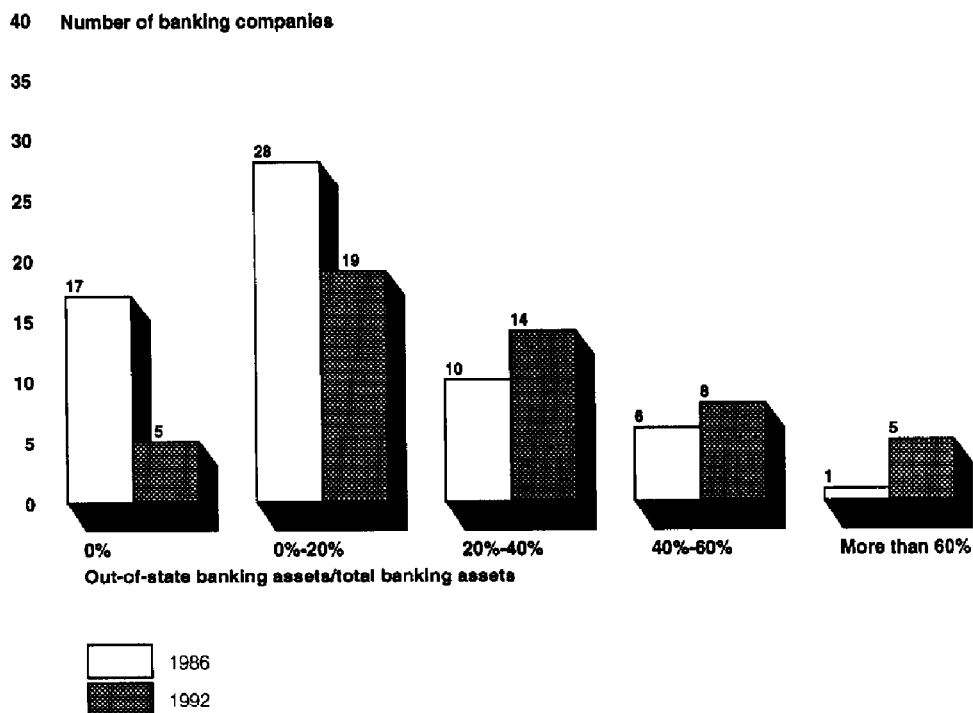
large U.S.-owned banking companies were held out of state in 1992, increasing from 12 percent in 1986. Furthermore, in 1986, only 10 U.S.-owned banking companies of the 68 banking companies with assets of \$10 billion or more held more than 30 percent of their bank assets in subsidiary banks located outside of their headquarters states. By 1992, that number had more than doubled, rising to 22, while the number of banking companies with \$10 billion or more in assets dropped to 56.⁶

The growing prominence of interstate banking activities among many large banking companies is shown in figure 3.2.

⁶Numbers for total large banking companies include foreign-owned banking companies. In 1986, six large banking companies were foreign-owned; in 1992, five were foreign-owned.

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Figure 3.2: The Percentage of Interstate Assets: Trends in the Number of Largest Banking Companies



Note 1: The percentage of interstate assets is measured as out-of-state banking assets divided by total banking assets.

Note 2: These banking companies include only those with more than \$10 billion in assets measured in 1992 dollars.

Note 3: Foreign banking companies are excluded, as all of their assets are considered to be held out of state.

Note 4: For 1986, there were 62 banking companies; for 1992, there were 51 banking companies.

Source: Call report data.

Primarily as a result of interstate banking, North Carolina, Ohio, Michigan, Rhode Island, Georgia, and Florida became home to 7 of the 20 largest banking companies in the country by 1992. (See table 3.1.) Eight banking companies have an interstate banking presence in at least eight states.⁶ The most states entered by any of these companies is 13.

⁶The banking companies are First Interstate, Norwest, Citicorp, NationsBank, BankAmerica, Boatmen's, Banc One, and Key Corp.

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Table 3.1: Location of the 20 Largest Bank Holding Companies

State	1985	1992
New York	8	7
California	4	3
Texas	3	0
Illinois	2	1
Pennsylvania	1	1
Minnesota	1	1
Massachusetts	1	0
North Carolina	0	2
Ohio	0	1
Michigan	0	1
Rhode Island	0	1
Georgia	0	1
Florida	0	1

Note: Data are for the periods ending December 31, 1985, and December 31, 1992.

Source: American Banker and Federal Reserve data.

The size of a number of the nation's large banking companies—both regional and money center—reflects, in part, the protection from competition outside the region or state that restrictive interstate laws have provided. These large banking companies may continue to predominate in their market areas for some time, even under nationwide banking, because they may be too large to make likely acquisition targets for most out-of-state banking companies.

Below the tier of large banking companies, many of the mid-sized banking companies that might have made attractive acquisition targets have already been acquired. For example, in 21 states and the District of Columbia, at least 3 of the 5 largest banking companies are already owned by out-of-state bank holding companies.⁷ In all, 102 (40 percent) of the 255 banks making up the 5 largest banking companies in each state plus the District of Columbia are owned by out-of-state bank holding companies.⁸

⁷These states are Arizona, Colorado, Connecticut, Delaware, Florida, Georgia, Idaho, Indiana, Iowa, Kentucky, Maine, Maryland, Nevada, North Dakota, Oregon, South Carolina, South Dakota, Texas, Utah, Washington, Wyoming, and the District of Columbia. (See app. II.)

⁸Control of a bank that is already owned by a domestic out-of-state banking company could, of course, change again if that out-of-state banking company is acquired by another.

Another notable feature of the change in large banking companies is the increasing diversity of headquarters states represented by the large banking companies that have substantial out-of-state operations. In 1986, large U.S.-owned banking companies with 30 percent of their assets in out-of-state subsidiaries had their headquarters in seven states. In 1992, they were headquartered in 16 states.⁹

As we mentioned earlier, it is to be expected that large banking companies will pursue a number of different business and expansion strategies. Thus, if interstate banking and branching laws were liberalized, not all banking companies would seek to expand their interstate operations. However, we believe it reasonable to conclude that such a liberalization would provide further encouragement to those banking companies already expanding their interstate operations.

Concentration at the National Level

The impact of larger banking institutions on concentration at the national level depends a great deal on the pattern of expansion that might occur under nationwide banking and branching. If a few banking companies seek a nationwide presence, then the share of the national market held by the largest banks could rise significantly. This is particularly true if the banking industry as a whole continues to shrink on a 1992 dollar basis. On the other hand, concentration among the largest banking companies could decrease if the pattern of growth were to result in a larger number of banks whose major activities were focused in one or a few regions.

On the basis of patterns of interstate expansion that occurred after state interstate laws were passed, it seems reasonable to assume under nationwide banking, some regional organizations will attempt to expand into states in which they do not currently have a presence. However, by itself, an increase in out-of-state acquisitions would not necessarily increase concentration among the very largest firms. For example, the number of large banking companies has risen in the Midwest states, while the percentage of assets in the region held by the three largest banking companies has fallen. (See table 3.2.)

⁹In 1986, the headquarters states and the number of bank holding companies headquartered there for the 10 domestic-owned banking companies with 30 percent or more of their assets in out-of-state subsidiaries were North Carolina (3), Georgia (2), California (1), New York (1), Massachusetts (1), Virginia (1), and Minnesota (1). In 1992, there were 22 such banks with headquarters in North Carolina (3), Minnesota (2), New Jersey (2), Ohio (2), Michigan (2), Alabama (1), California (1), Connecticut (1), Georgia (1), Massachusetts (1), Missouri (1), New York (1), Oregon (1), Rhode Island (1), Virginia (1), and Wisconsin (1). In addition, there were six foreign-owned, multistate banking companies in 1986 and five in 1992.

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Table 3.2: Concentration Ratios of the Three Largest Banking Companies in Selected Regions and the United States

Location	Concentration ratios		Percentage change
	1986	1992	
New England ^a	43.4%	53.6%	23.5%
Southeast	15.5	24.9	60.6
Midwest	21.3	16.9	-20.7
United States	12.8	14.4	12.5

Note: Data are for the periods ending December 31, 1986, and December 31, 1992.

^aNew England ratios do not include savings banks and consequently are relatively high because savings banks play a significant role in New England's banking industry.

Source: Call report data.

It is, however, entirely possible that some of the nation's largest, well-capitalized banking companies would take advantage of the opportunities afforded by liberalized interstate banking and branching laws to acquire a significant presence in a large number of markets throughout the United States. Were this to occur, concentration at the national level among the largest banking companies could increase. For example, increases in regional concentration among the largest three banking companies in both the Southeast and New England regions followed the liberalization of interstate banking laws in those regions. (See table 3.2.)

To illustrate this point with a hypothetical example, if a banking company were to acquire a 20-percent market share in half of the metropolitan area markets in the country, it could grow to about \$300 billion in assets. If there were three such banking companies in the country, the national concentration ratio of the three largest banking companies would rise to about 25 percent from 15 percent at year-end 1992.¹⁰ Were interstate banking to develop along these lines, some states that currently have experienced relatively low rates of out-of-state entry—particularly states

¹⁰Some have noted that U.S. banks are relatively small as measured by the largest banks in the world. Although size is by no means a complete measure of capability to perform well in world markets, consolidation such as that contained in the above example—i.e., 3 large banking companies with an average of about \$300 billion in assets—would result in the United States having at least 3 banking companies in the 20 largest of the world. In recent years, no U.S. banks were among the 20 largest in the world.

The example is hypothetical, based on the assumption that the three banking companies gain 20 percent of domestic deposits in one-half the Metropolitan Statistical Areas, and that their other funding sources and domestic deposits in non-Metropolitan Statistical Areas do not grow. To the extent that either of these other funding sources grows, their market share could become even greater. To the extent that these domestic deposits are substituted for other funding sources, their growth would not be as great.

that headquarter some of the nation's larger banking companies—would likely have increased entry from out-of-state banking companies. For example, the states of New York, California, Michigan, Ohio, and North Carolina, which together account for about 40 percent of the nation's banking assets, all have less than 10 percent of their assets owned by domestic out-of-state banking companies.

Critics often raise the concern that liberalization of federal interstate banking and branching laws would lead to as much concentration of the largest banks at the national level in the United States as in many other countries. Yet analysts with whom we spoke said this would be unlikely. First, the pattern of interstate banking to date may make the creation of a nationwide banking network more arduous, since the market in many metropolitan areas is dominated by large regional banks that would make difficult acquisition targets. Second, according to a study by the Federal Reserve Bank of Chicago, high national concentration levels in foreign countries may be partially explained by "regulations that limit the availability of new bank charters, restrict the ability of foreign banks to compete in the domestic market, and prevent thrifts from offering a broad array of banking services."¹¹ In Canada, for example, before 1980, de novo entrants faced significant barriers to entry—such as high capital requirements and the requirement that new charters could be obtained only by an act of Parliament. U.S. banks do not currently face such barriers.

State and Local Concentration Levels

Potential changes in the direction of the concentration levels of the largest banks are more difficult to predict at the state or local levels, since each state and local market is subject to unique economic and other influences and because there is considerable variation in the current concentration levels in individual states. Although concentration levels have declined in a number of states and local markets, they have risen in others.

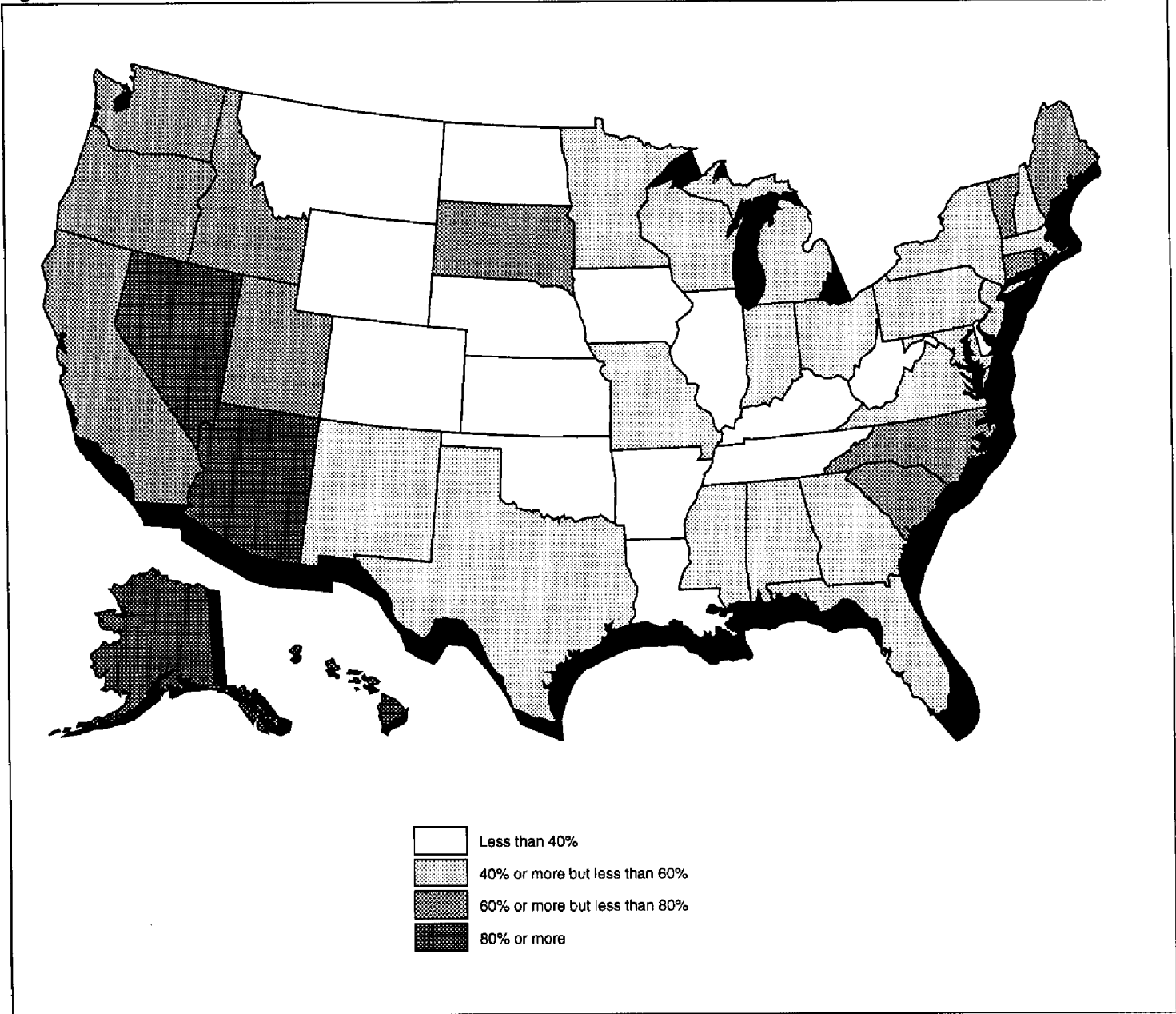
State Concentration Ratios

Sixteen states and the District of Columbia have concentration ratios for the three largest banking companies of 60 percent or more (in five of these states the ratios are over 80 percent). At the lower end, 15 states have concentration ratios of 40 percent or less (2 of which are 25 percent or less). (See fig. 3.3.)

¹¹Baer, Herbert and Larry Mote, "The Effects of Nationwide Banking on Concentration: Evidence From Abroad," in *Toward Nationwide Banking*, Federal Reserve Bank of Chicago (Chicago: 1986).

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Figure 3.3: Concentration Ratios of the Three Largest Banking Companies by State as of December 31, 1992



Source: Call report data.

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The difficulty in predicting how a change in interstate banking laws could affect the concentration ratios at the state level is illustrated by the effect consolidation has had on concentration ratios in states within the Southeast regional compact. Even as concentration increased in the region as a whole, it decreased or remained level in 6 of the region's 13 states and the District of Columbia. In two of the states, however, concentration ratios increased significantly more than they did in the region as a whole.¹² (See table 3.3.)

Table 3.3: Changes in the Concentration Ratio of the Three Largest Banking Companies in Each State in the Southeast Region and the Region as a Whole

	Concentration ratios of the three largest banking companies		
	1986	1992	Absolute change
Florida	43%	60%	+17
West Virginia	24	37	+13
Mississippi	37	42	+5
Louisiana	34	38	+4
Arkansas	22	26	+4
Alabama	53	55	+2
Kentucky	36	38	+2
Maryland	43	45	+2
District of Columbia	72	71	-1
South Carolina	65	63	-2
Tennessee	43	40	-3
Virginia	48	44	-4
North Carolina	71	66	-5
Georgia	53	48	-5
Southeast region	15	25	+9

Note 1: Data are for the periods ending December 31, 1986, and December 31, 1992.

Note 2: Concentration ratios reflect mergers that were completed by the end of 1992. A number of mergers have been completed or announced between banking companies in these states since then and will alter these numbers.

Note 3: Totals may not add due to rounding.

Source: Call report data.

¹²Concentration levels reflect mergers that were consummated by the end of 1992. A number of mergers have been consummated or announced between banking companies in these states since then.

By removing geographic barriers, a federal law permitting interstate banking could help decrease state concentration levels if the presence of out-of-state banks reduces the dominance of existing large banking companies. However, if interstate bank holding company mergers involve banks that have a presence in the same state(s), state concentration levels could increase. Experience with consolidation and interstate banking to date suggests that neither of these factors alone is sufficient to explain changes in state concentration levels between 1986 and 1992. Table 3.4 indicates that there is no consistent relationship between out-of-state ownership and changes in the concentration level of the three largest banking companies. For example, 16 states and the District of Columbia had high out-of-state ownership levels, but in 8 of these, the concentration level fell from 1986 to 1992. Conversely, in the 13 states with low out-of-state ownership levels, 4 states had concentration levels that increased by more than 20 percent over the period.¹³

Table 3.4: Changes in Concentration Ratios of Each State's Three Largest Banking Companies Compared to the Percentage of Out-of-State Ownership of Each State's Banking Assets

Percentage of out-of-state ownership for 1992	Number of states where the change			Total
	Falls	Rises by less than 20 percent	Rises by 20 percent or more	
High (40% or more)	8 ^a	5	4	17
Medium (less than 40% but more than 10%)	9	9	3	21
Low (10% or less)	2	7	4	13
Total	19	21	11	51

Note 1: For more detailed information on the states in each category, see table II.6.

Note 2: Changes in concentration ratios are for the period December 31, 1986, to December 31, 1992.

^aIncludes the District of Columbia.

Source: Call report data.

Local Concentration Levels

The potential impact of consolidation on local market concentration levels is even less clear than at the state level; it will depend largely on whether

¹³Increases in concentration at the state level may also result from other factors, including mergers between in-state banking companies or asset growth in the state's largest banking companies. Similarly, decreases in concentration levels may result from asset sales or other asset shrinkage among the largest banking companies or a loss of market share by the three largest banking companies to smaller banking companies in the state.

consolidation occurs through market extension or in-market mergers.¹⁴ Removal of interstate banking restrictions will, at least in the short run, provide more opportunities for market extension mergers that have less of an impact on local market concentration levels than in-market mergers.

The banking structure in local markets could actually become less concentrated if banking companies were to expand through de novo interstate banking or branching. Such activity is most likely by banking companies located in the proximity of state borders. These banking companies might simply wish to establish a presence across the border in the least expensive way possible, whether through de novo branching, de novo banking, or acquisition.¹⁵

De novo bank expansion could counteract the potential for local market concentration increases, at least in the short to medium term. Indeed, the relaxation of in-state branching laws and interstate banking laws to date appears to have counterbalanced some of the concentrating effects of consolidation. In spite of the consummation of almost 5,000 bank mergers in the 1980s, data from the Federal Reserve show the average concentration level of rural and urban banking markets has remained constant between 1980 and 1991. (See table 3.5.) Furthermore, although there is a considerable range in the concentration levels of the various urban markets, there were fewer urban markets in which the three largest banking companies controlled 70 percent of the market in 1991 than was the case in 1986—or even a decade before that.¹⁶

¹⁴In a market extension merger, an out-of-market banking company enters the market by purchasing an existing banking company. This does not increase concentration in that market, it only changes ownership. In-market mergers, on the other hand, do result in an increase in concentration because two banking companies within the same market are combined.

¹⁵Although most banking companies can already enter their neighboring states, they are not allowed to do so through branching but must utilize separate subsidiary banks. De novo interstate entry is also generally prohibited.

¹⁶In 1991, 130 out of 318 urban markets had concentration ratios for the three largest banking companies of 70 percent or greater. In 1986, the ratio exceeded 70 percent in 147 out of 318 urban markets. In 1976, the ratio exceeded 70 percent in almost half of the markets—153 out of 318 urban markets.

Table 3.5: Average Market Share of the Three Largest Banking Companies in Urban and Rural Markets

Year	Market share percentage	
	Urban	Rural
1980	66.5%	89.6%
1981	66.1	89.4
1982	65.9	89.4
1983	66.0	89.4
1984	66.4	89.4
1985	66.8	89.5
1986	67.5	89.5
1987	67.7	89.6
1988	67.8	89.7
1989	67.5	89.7
1990	67.3	89.6
1991	66.7	89.3

Source: Federal Reserve data.

Once a number of banking companies have established nationwide banking operations, mergers among large banking companies will more likely involve numerous overlapping markets. Consequently, some local market concentration levels will increase as well as national concentration levels.

The difficulty of predicting long-run changes in local market concentration can be illustrated by looking at California. Local market concentration varies considerably even though there have been no geographic barriers to banking in California for quite some time. Some local markets are two, three, or even four times as concentrated as others. Furthermore, a merger of large banking companies, such as that of Bank of America and Security Pacific, can quickly change local market concentration levels, increasing them by a third or more in some cases.

Community Banks

There is no question that consolidation in the banking industry has been accompanied by a decrease in the number of banking companies with less than \$1 billion in assets. It is interesting to note, however, that the percentage decrease in the number of these banking companies was just slightly less than that for banking companies with \$10 billion or more in assets measured in 1992 dollars—17.1 percent versus 17.6 percent.

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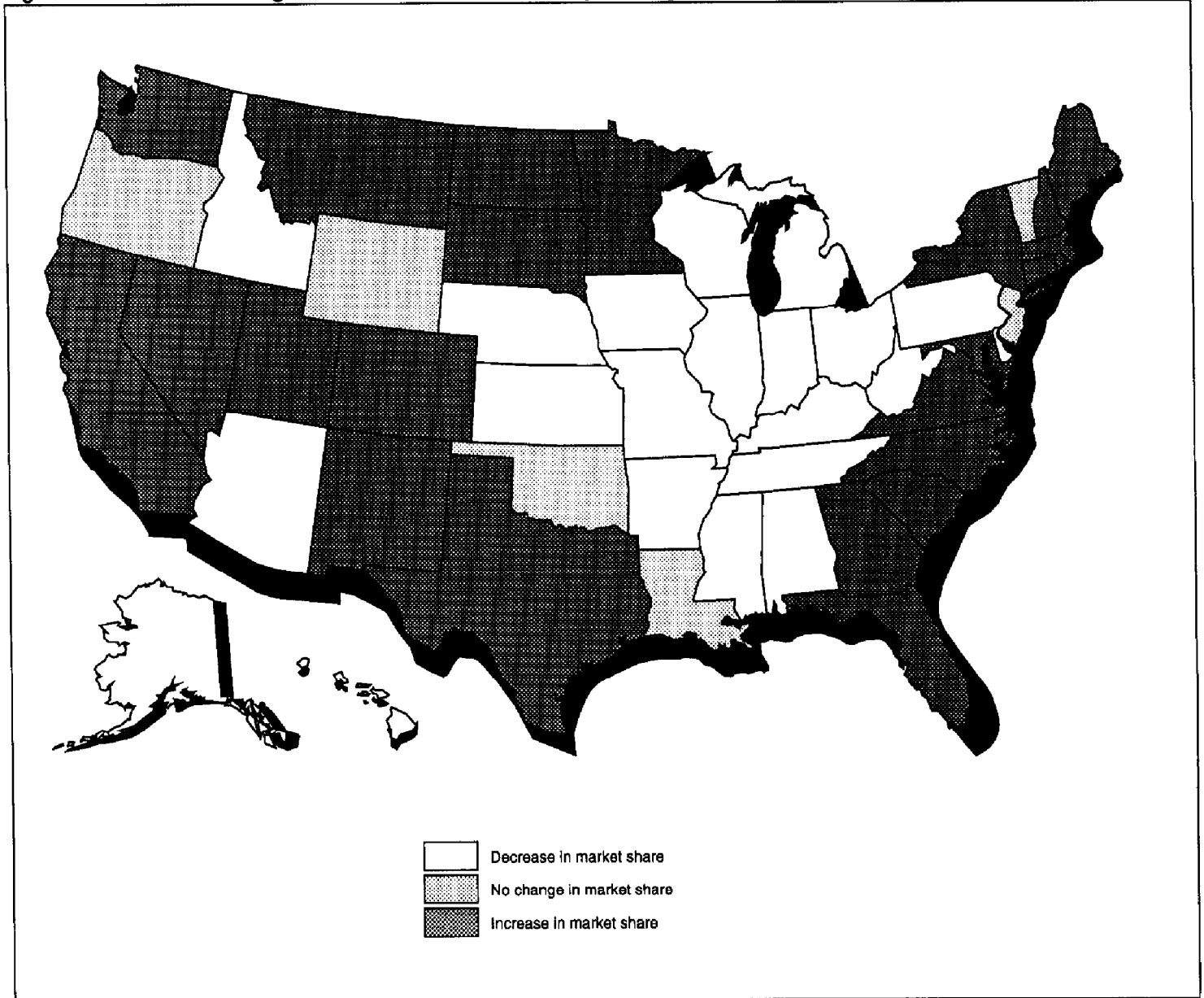
We analyzed the changes in the market share of community banks over the period 1986 through 1992 to determine whether interstate banking may have been a determining factor in this decline. Because perceptions of what constitutes a community bank vary, we divided community banking companies into four classes: banking companies with \$100 million or less in assets, \$300 million or less, \$500 million or less, and \$1 billion or less. We adjusted the data to eliminate the impact of inflation on the size of banking companies to ensure that no banking company changed size simply as a result of inflation.¹⁷

We found that the market share of at least 3 of the 4 community banking company classes increased in 24 states and the District of Columbia and decreased in 21 states. In the six remaining states, market share increased for two size classes and decreased for the other two. (See fig. 3.4.) Notably, community banking companies gained market share in California, Massachusetts, and North Carolina, states that have had long histories of statewide branching and have high levels of bank concentration.

¹⁷The adjustment was done using 1992 dollars.

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Figure 3.4: Direction of Changes in Market Share of Community Banking Companies by State for 1986-92



Source: Call report data.

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If interstate banking were to have a negative effect on community banking companies, then states with a large percentage of out-of-state ownership might be expected to have experienced declines in the market share of these banking companies. Yet, of the 21 states where community bank market share declined, 9 had out-of-state ownership ratios below 10 percent, while 5 had out-of-state ownership ratios above 40 percent. Similarly, the community bank market share rose in the District of Columbia and nine states with high out-of-state bank ownership and in only two states with low out-of-state ownership. (See table 3.6.)

Table 3.6: Changes in Community Bank Market Share and Out-of-State Ownership of State Banking Assets

Percentage of out-of-state ownership for 1992	Number of states where the market share was			
	Falling	Rising	Mixed	Total
High (40% or more)	5	10 ^a	2	17
Medium (less than 40% but more than 10%)	7	12	2	21
Low (10% or less)	9	2	2	13
Total	21	24	6	51

Note 1: Four size classes were used to define community banks: \$1 billion or less in assets, \$500 million or less, \$300 million or less, and \$100 million or less. If at least three of the four size classes in a state showed increased market share, the community bank market share was classified as rising. If at least three of four fell, the market share was classified as falling. If two rose and two fell, the market share was mixed.

Note 2: For more detailed information on the states in each category, see table II.8.

Note 3: Changes in market share are for the period December 31, 1986, to December 31, 1992.

^aIncludes the District of Columbia.

Source: Call report data.

The decline in community banking companies is more likely related to changes in in-state branching laws than to interstate banking. For example, from 1986 through 1992, two states that liberalized their branching laws—Texas and Illinois—accounted for about 30 percent of the decrease in the total number of banking companies.

Evidence from interstate banking to date, the ability of community banking companies to operate profitably, and an analysis of the literature on economies of scale show, we think convincingly, that it is possible for all but perhaps the smallest banking companies to compete successfully

with larger ones. Even though there are fewer community banking companies, their market share nationally and in many states has remained stable or even increased.¹⁸ This implies that community banking company assets have generally not been acquired by large banking companies. It is important to note, however, that even when market share at the state level increases, some individual communities may experience a decline in the number or size of community banking companies as a result of failures, acquisitions, or simply decreases in deposits held by individual community banking companies.

Experience to date, however, does not ensure a growing or even a stable market share for community banking companies. Their viability will depend on how well they serve their communities and how efficiently they are managed. Relatively small changes in the market share of community banking companies can have a large impact on their number. For example, if the market share of banking companies with \$100 million or less in assets (adjusted for inflation) dropped from the current 8 percent to 5 percent, the number of community banks could drop by more than 2,000;¹⁹ conversely, the number (or the average size) of such banks would increase if the market share rose to 10 percent.

The sensitivity of the community bank sector to relatively small changes in market share makes it particularly difficult to assess the potential impact of nationwide banking on this part of the banking industry. Many community banking companies seem to offer services that compete well in local markets compared with those offered by larger banking companies. Yet, although acquiring banking institutions tend to focus on larger banking companies in order to obtain significant market shares, small acquisitions may sometimes be the preferred or only option for entering a market. For example, several large out-of-state banking companies have acquired community banks in Washington and Arizona.²⁰ Furthermore, some established banking companies might acquire community banks to reduce competition in local markets or to make it harder for others to

¹⁸Consequently, the average size of community banking companies has increased.

¹⁹A change from 8 percent to 5 percent in market share means a reduction in assets held by these banks of about \$100 billion. Assuming that their average bank size stays at \$25 million, this would mean the elimination of about 2,400 small banks.

²⁰For example, in Arizona 29 community banks with less than \$1 billion in assets were acquired by out-of-state bank holding companies between 1986 and 1992. Of these 29, 10 had failed. In Washington, West One, an Idaho bank holding company, acquired five community banks with total assets of \$287 million between 1988 and 1992. U.S. Bancorp, headquartered in Oregon, acquired four community banks with total assets of \$282 million between 1987 and 1989.

enter the market by acquisition. However, this is not a problem specific to interstate banking or branching.

While interstate banking operations are dominated by large banking companies, banking companies with less than \$1 billion in assets have expanded their interstate operations in the past few years. By 1992, 73 banking companies with less than \$1 billion in assets had expanded interstate—more than 6 times the number in 1986. Their proportion of interstate activity remains small, however, as they control only 4.4 percent of the banking assets held in out-of-state subsidiaries. (See table 3.7.)

Table 3.7: Assets in Out-of-State Bank Subsidiaries by Size Class of Banking Company

Dollars in billions

Size of banking company (measured in 1992 dollars)	Number of banking companies engaged in interstate banking		Assets held in out-of-state subsidiaries of interstate banking companies		
	1986	1992	1986	1992	Percentage change
\$10 billion or more	54	52	\$311	\$677	176%
\$1 billion-\$10 billion	37	65	42	56	33
\$100 million-\$1 billion	7	53	0.6	4	567
Less than \$100 million	4	20	0.1	0.4	300
Total	102	190	\$353	\$738	109%

Note: Data are for the periods ending December 31, 1986, and December 31, 1992.

Source: Call report data.

The way in which federal interstate banking legislation is framed could be particularly important to smaller banking companies. If banks were allowed to expand across state lines by establishing de novo branches (rather than by having to acquire an existing bank), smaller banking companies, especially those located close to state borders, would find it easier to take advantage of interstate market opportunities because the costs of expansion could be relatively low.

A Closer Look at the Possible Impact on Individual States

The passage and liberalization of interstate banking laws at the state level have obviously contributed to changes in the banking industry's structure. Interstate banking has opened up a wider range of consolidation opportunities. Yet, permitting interstate banking has been a necessary but not sufficient condition for interstate expansion. Actual entry has depended on several other variables.

Several bank analysts have tried to estimate how the structure of the banking industry might evolve at the end of a decade or more of unrestricted interstate banking by analyzing trends in California and other states and regions. Some have suggested that the number of banks might be reduced by one-fourth or one-half, with significant increases in concentration at the top. For example, a recent study estimates that there would be about 5,500 independent banking companies in 2010,²¹ compared to 9,908 in 1989. It also projects that while the proportion of domestic banking assets accounted for by the largest 50 and 100 banks would rise to about 70 and 87 percent, respectively, from 52 and 65 percent in 1989, there would continue to be more than 5,000 community banks with less than \$1 billion in assets.

We caution, however, as do the authors of the study cited, against putting too much stock in projections as specific as these. Considerable variation is possible in the structure of the banking industry, and there is no reason to assume that the future will simply be an extension of past trends.

General Characteristics of Interstate Acquirors and Banking Companies That Are Acquired

Experience provides enough insight to delineate some relatively broad trends that are likely to continue under nationwide banking. These trends concern the general nature of consolidation and competition in the banking industry. According to a study by Shoenhair and Spong of the Federal Reserve Bank of Kansas City,²² a number of factors help determine which bank holding companies are likely to expand interstate and where they will make acquisitions. These factors include the entered state's banking structure and its economic condition, the financial condition of the state's banking companies, and the financial condition of the potential acquirors.

On the basis of interstate activity through 1988, the study came to the following conclusions:

- Larger organizations are more likely to have the resources to make interstate acquisitions and are less attractive acquisition targets, while small- to medium-sized organizations may be more natural acquisition targets. States with large banking companies had low entry rates from

²¹Hannan, Timothy and Stephen Rhoades, "Future U.S. Banking Structure: 1990 to 2010," *Antitrust Bulletin*, Fall 1992, pp.737-798.

²²Shoenhair, John and Kenneth Spong, *Interstate Bank Expansion: A Comparison Across Individual States*, Study for the Federal Reserve Bank of Kansas City, January 5, 1990.

- out-of-state bank holding companies, lending support to the assumption that larger banking companies make more difficult acquisition targets.
- States with banking structures that were more concentrated experienced significant entry from other states' bank holding companies, but they also headquartered bank holding companies with high interstate expansion levels. The study concludes that this has two ramifications. First, a significant market share is easy to acquire in such states, thus making entry attractive. Second, larger banks are more likely to expand into other states, explaining the high expansion level from states that are highly concentrated.
 - Banking companies whose financial condition is healthy are more likely to be acquisition targets and are more likely to expand interstate.
 - Much interstate entry has been directed toward states with above average banking returns and growth and with favorable economic conditions. This would help explain why New England states, for example, did not experience much entry from outside of the region after regional reciprocal restrictions were lifted.

The study concludes that over the long term, interstate activity should move banking resources from less profitable, overbanked areas into areas that are underbanked.

One major exception to the pattern of entry and expansion discussed in the study has developed since the study was undertaken. Entry into some states has been precipitated by extensive financial difficulties in the banking sector in those states, resulting in bank failures and failed bank acquisitions by out-of-state banking companies. The acquisition of weak banks by out-of-state banking companies can be expected to continue to be an important factor as more experience is gained with the tripwire and early closure provisions of FDICIA.²³

Out-of-State Entry to Date

Experience with interstate banking supports the thesis that the type of interstate law enacted is not sufficient to determine interstate entry. For example, only 5 percent of Louisiana's banking assets are owned by out-of-state banking companies even though that state has a nationwide reciprocal statute and is part of the Southeast regional reciprocal compact. Other states with more restrictive interstate laws have much higher rates of out-of-state ownership—69 percent in South Carolina, 52 percent in Florida, and 39 percent in Maryland.

²³See chapter 5 for additional discussion.

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Table 3.8 categorizes, by interstate banking law, the percentage of each state's banking assets that are owned by out-of-state banking companies. There is considerable variation within each category of interstate law. Of the 16 states plus the District of Columbia that have more than 40 percent of their assets owned by out-of-state banks, 9 allow nationwide banking, 5 allow nationwide reciprocal banking, and 3 allow regional reciprocal banking.

The same variation is apparent in states with relatively little out-of-state bank ownership. Of the 13 states that currently have less than 10 percent of their banking assets owned by out-of-state banking companies, 5 have relatively liberal interstate laws, and 8 have restrictive laws.

Table 3.8: Percentage of Out-of-State Ownership by State by Interstate Banking Laws

Interstate banking laws	Number of states with out-of-state ownership			Total
	40% or more	Less than 40% but more than 10%	10% or less	
Nationwide	9 ^a	5	0	14
Nationwide reciprocal	5	11	5	21
Regional reciprocal	3	4	7	14
No interstate banking	0	1	1	2
Total	17	21	13	51

Note 1: For more detailed information on the states in each category, see table II.4.

Note 2: Data are for the period ending December 31, 1992.

^aIncludes the District of Columbia.

Source: Federal Reserve, Conference of State Bank Supervisors, and call report data.

This experience illustrates that allowing nationwide banking will not automatically increase interstate entry into the states with restrictive laws and that continuing nationwide restrictions will not necessarily limit out-of-state entry.

A state's fundamental economics have proven to be a somewhat better predictor of interstate entry. For example, of the 11 states whose rate of employment grew by more than 10 percent between 1986 and 1991, 7 experienced high interstate entry. Of the four states plus the District of Columbia in which employment growth was negative, only the District of

Columbia had high entry. Yet, even high employment growth has not guaranteed a high level of interstate entry. Ten of the 35 states with employment growth rates of more than 5 percent have less than 10 percent of their banking assets owned by out-of-state banking companies. (See table 3.9.)

Table 3.9: Changes in Employment Between 1986 and 1991 and Out-of-State Ownership of State Banking Assets

Percentage of out-of-state ownership for 1992	Number of states with employment growth rates of					Total
	Less than 0%	0 to 4.9%	5 to 6.9%	7 to 9.9%	10% or more	
High (40% or more)	^a	2	2	3	7	15
Medium (less than 40% but more than 10%)	3	5	5	6	2	21
Low (10% or less)	1	4	5	3	2	15
Total	5	11	12	12	11	51

Note: For more detailed information on the states in each category see table II.11.

^aIncludes the District of Columbia.

Source: Call report and Department of Labor data.

This supports the conclusion that no one factor is likely to be sufficient to predict where banking companies may expand. Actual interstate entry will depend on a number of variables, including but not limited to, individual states' economic strengths and their interstate banking laws.

Impact on the Rate of Consolidation

The impact of a federal nationwide banking and branching law on the rate of consolidation cannot be estimated accurately. Many market participants believe that any additional consolidation would be gradual; that banking companies would continue to expand into nearby states before expanding further; and that as a practical matter, it takes time for companies to digest large-scale acquisitions. Whatever the impact, the immediate reaction will depend upon how constrained banking companies are under the current laws.

It is possible, though, that banking companies might perceive a law permitting nationwide banking as a signal that mergers are being encouraged and would consequently accelerate interstate mergers, even in

states that are already open to them, simply as a response to that signal. This opportunity could precipitate a rapid jump in merger activity if banking companies feel pressured by competition to quickly acquire the most attractive targets that have become available. The pace of consolidation could also accelerate if the markets reacted so favorably to a nationwide banking law that capital to make acquisitions became cheaper.

Conclusions

It is impossible to predict exactly how nationwide banking and branching would affect the banking industry's structure. However, the factors that have contributed to industry consolidation—both inter- and in-state—are likely to remain influential whether or not federal interstate statutes are changed. Nationwide banking and branching will provide additional opportunities for interstate expansion that are likely to increase consolidation and may change its pattern.

Although considerable variation is possible in the structure of the industry, past experience with interstate banking on state and regional levels, and with in-state branching, provides the basis for several conclusions. First, increasing the range of opportunities for interstate expansion is likely to encourage the creation of larger banking companies that are more geographically diversified. Depending on their business strategies, some of the largest organizations may also be encouraged to take advantage of the opportunity to establish a presence in metropolitan areas nationwide, while others may simply extend the region in which they wish to do business. In any case, national and regional concentration levels are likely to increase, although the degree to which this will affect concentration in just the three largest national or regional firms is uncertain.

Second, although the total number of banks in the United States would likely fall, thousands of small banks would likely survive to provide competition for the largest banks in local markets. If this ability of smaller banks to compete continues to reflect past trends, their share of total bank assets should remain relatively stable. In general, local market and state concentration levels would remain more stable than national or regional levels and in certain cases may become less concentrated as a result of heightened competition.

Changes in the industry structure on national and regional levels are somewhat easier to estimate than changes at the state level. Unique economic and banking structure characteristics in individual states and

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markets will affect the amount of interstate entry and its effect on consolidation. Ultimately, the structure of the banking industry will be shaped more by market forces—particularly competition—than changes in federal laws, as discussed in the previous chapter.

Even though competition is generally viewed as a positive factor, markets are regulated to ensure that they serve the public interest. Because there are no criteria for establishing the optimum number of banking companies needed to serve the economy, it is important that safety and soundness, community convenience, and antitrust regulation adjust to changes in the industry to ensure that the public interest is being served. The impact of these three categories of regulation is discussed in the following chapters.

Safety and Soundness: Potential Benefits to the Health of the Banking Industry and Risks to BIF

Chapter Summary

Topic	Principal Findings	
<p>This chapter discusses the potential improvements to the health of the banking industry as well as the potential risks to BIF associated with interstate banking and branching.</p>	<p>Interstate banking and branching could strengthen banks by increasing opportunities for asset and liability diversification and reducing the cost of such diversification. This also could strengthen banks by creating potential cost savings by allowing multistate bank holding companies to convert bank subsidiaries into branches.</p>	<p>It is not possible to generalize about the net effect of nationwide banking and branching on profitability for any particular bank because many factors affect bank performance.</p>
	<p>Conversely, some banking companies might be tempted by nationwide banking and branching to expand too rapidly or take other unmanageable risks.</p>	<p>Potential risks associated with interstate banking are similar to those of large banking companies without interstate operations.</p>
		<p>Potential risks to BIF underscore the importance of effective regulation and supervision.</p>

Liberalized interstate banking and branching laws would provide opportunities that would strengthen many banking companies as they try to serve markets as efficiently as possible. These benefits arise primarily from improved diversification of assets and funding sources and from cost savings. In a market environment, however, these benefits cannot be considered automatic, and some banking companies may not fare well in the face of additional competition. There are, therefore, risks that must be addressed to ensure that liberalizing federal interstate banking and branching laws do not place BIF at risk.

Potential Benefits to Safety and Soundness

Potential safety and soundness benefits from interstate banking and branching fall principally into two areas: diversification and cost savings. In any particular instance, the realization of such benefits depends largely upon how individual institutions are managed. These benefits are not necessarily limited to nationwide expansion or consolidation, although more opportunities for diversification or cost savings would be available if geographic restrictions to expansion were removed.

Asset Diversification

When a bank's assets are not geographically diversified, the quality of its balance sheet can be severely affected by fluctuations in the local economy. Even if a bank makes a variety of loans—consumer, small

business, real estate, or farm—if the local economy suffers a downturn, a large proportion of these loans may be negatively affected. Geographic diversification provides an opportunity for economic fluctuations to offset each other in markets in which the bank lends.

This principle of portfolio diversification is well recognized in financial markets and the economics literature. Consequently, small banks that are generally more confined geographically than larger ones typically have higher capital ratios and lower loan ratios to compensate for their lack of diversification.

Although banks are not prohibited from lending in markets in which they have no physical presence, interstate banking restrictions may limit the effectiveness of such lending in reducing risk or may increase its cost. For example, Federal Reserve officials told us that out-of-territory loans do not perform as well as in-territory loans because information on borrowers or local economies is harder to obtain and monitoring costs are higher as distance from a borrower increases. If information is insufficient or monitoring is not adequate, loan losses may increase, thus negating the beneficial effects of diversification.¹

Establishing bank subsidiaries or branches in other areas, on the other hand, may improve a banking company's knowledge about its borrowers and the local markets in which they reside and reduce the cost of gathering information and monitoring loans. To the extent that information reduces loan losses, a banking company's efforts at geographic diversification will be successful, thus improving its safety and soundness.

We would caution, however, that expansion into different states does not guarantee diversification if the economies of these states are dependent on the same industries or other economic determinants. Some banking companies may find it necessary to expand into a different region to diversify their risks. Furthermore, geographic diversification will not ensure that lending risks are controlled or priced correctly.² Increased opportunities for geographic expansion simply give bank management more options for controlling their risks.

¹For example, loans purchased from Penn Square by Continental, Seattle First, and a number of other banks in the early 1980s resulted in large loan losses for these banks because of a lack of accurate information about these loans.

²For example, if lending by industry is not diversified, a banking company, no matter how well diversified geographically, may still suffer from an undiversified portfolio and could experience losses if that industry suffers a downturn.

Domestic Deposits and Diversification of Funding Sources

The potential benefits of geographic diversification are not limited to a banking company's loan portfolio; they may also be important in broadening the banking company's sources of funds. Banks that are restricted geographically may not have access to a large, stable domestic deposit base.³ If they wish to grow, they must attract more volatile funds from nonlocal sources. Large banks that have been restricted geographically, particularly the money center banks, have historically relied more heavily than other banks on foreign deposits and deposits of more than the \$100,000 FDIC insurance limit to finance their assets. Increasing their deposit base through geographic expansion could decrease the volatility of their liabilities, thus reducing their susceptibility to runs and improving their safety and soundness.

The widely differing experiences of Continental and Bank of America in the mid-1980s support the contention that limiting a bank's geographic area of operation hinders its ability to develop a domestic deposit base. Continental was restricted by state law to a physical presence in Chicago, where it was headquartered. In order to grow, it was forced to rely on funding—primarily uninsured deposits and foreign deposits—raised outside the Chicago area.⁴ Ultimately, Continental's rescue by FDIC was precipitated by a run of holders of these liabilities.

By contrast, Bank of America, which also experienced asset problems in the mid-1980s, was able to work out its problems without requiring FDIC assistance. One market participant attributed Bank of America's ability to do this to its large retail network, which provided a stable source of funds and revenues on which the bank could rely while resolving its troubles.

Since the failure of Continental, the reliance of banking companies on domestic deposits has increased (see table 4.1). A major reason for this shift is the potential liquidity problems with purchased funds. If nationwide banking were authorized, banking companies might take advantage of the increased access to domestic deposits to change their funding mix in ways that would make their liabilities less volatile. From our analysis of call report data, we found that as a whole, out-of-state banks owned by interstate bank holding companies have higher proportions of domestic deposits than the holding company's bank subsidiaries that are located in the headquarters state of the holding

³In this section, domestic deposits refers to total domestic deposits minus large time deposits.

⁴In 1984, shortly before Continental received financial assistance from FDIC, it had 16 percent of its funding in domestic deposits compared with 27 percent for comparably sized banks and 52 percent for the industry as a whole.

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company. Thus, as these holding companies have expanded, the banking company's proportion of domestic deposits has increased.

Table 4.1: Trends in Funding Sources for Banks

Dollars in billions				
	Amount		Percentage of assets	
	1984	1992	1984	1992
Funding sources				
Domestic deposits ^a	\$1,637	\$2,396	65.5%	68.7%
Other liabilities ^b	708	829	28.3	23.8
Equity capital	153	262	6.1	7.5
Total assets	\$2,498	\$3,487		

Note: Data are for the period December 31, 1984, to December 31, 1992.

^aFDIC estimates that about three-quarters of these deposits are insured.

^bIncludes foreign deposits.

Source: Call report data.

Cost Savings Benefits From Interstate Banking and Branching

In chapter 2, we pointed out that many analysts believe opportunities for reducing costs through realization of economies of scale and improving managerial efficiency are possible within the banking industry. Although mergers are not essential for the realization of such savings, many analysts believe that in practice, it is through mergers that most of these savings are likely to be realized. They believe that mergers often are necessary to provide the impetus for managers to cut staff and redefine bank operations and products. Most of the savings, however, come from in-market mergers and are associated with branch consolidation. Market extension mergers, which tend to be associated with interstate banking, provide fewer opportunities for cost savings from the elimination of redundant operations.

The power to branch interstate, on the other hand, creates potential cost savings that are primarily the result of the ability of multistate bank holding companies to convert bank subsidiaries into branches. Some of the cost savings associated with simplifying the complicated multibank holding company structure include the elimination of separate boards of

directors and auditors, regulatory reports, and full-scope examinations for each bank subsidiary.⁵

Some banking companies have estimated how much they could save if they were able to consolidate bank subsidiaries into branches under interstate branching. NationsBank and BankAmerica, for example, have indicated that they could save an estimated \$30 million to \$50 million per year. For 1992, such savings would have amounted to about three-quarters of 1 percent of their noninterest expenses. Savings of this magnitude correspond to approximately 4 percent of earnings.⁶

Although we cannot verify the NationsBank and BankAmerica estimates, some bank regulators indicated that they are reasonable, particularly since the estimates include only reductions in the administrative costs associated with the current banking structure. The regulators could not, however, provide us with a cost analysis of their own.

Other costs associated with maintaining the degree of separateness among banks within a holding company required by regulation would also be reduced significantly if interstate branching were allowed. A number of bankers and others believe that the biggest benefit from lifting interstate branching restrictions—but one that is difficult to quantify—would result from the more efficient allocation of capital within a banking company. For example, to share a loan among the banks within a holding company, each bank must conduct its own due diligence review, maintain credit and collateral files, and separately approve the loan. Such costs would not arise among interstate branches because capital is maintained at a bank, not a branch, level. Because lending limits would be tied to the capital of the combined banks as one consolidated company and not to the capital of each individual bank, the participation of loans or movement of capital among bank subsidiaries belonging to the same holding company would no longer be necessary. Furthermore, the elimination of separate bank

⁵At the bank level, reports and examinations cover bank condition and income, consumer compliance, securities compliance, currency tracking, and consumer credit policies. In addition, each bank must prepare separate budgets, management reports, and board reports.

⁶We calculated this order of magnitude using the average earnings and noninterest expenses of the 50 largest banking companies in 1992.

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capital requirements for each interstate operation would also eliminate the duplication of capital when funds are moved within the company.⁷

The streamlining of the processing of payments provides another area of cost savings associated with interstate branching. Consolidating banks within a holding company could increase the number of checking accounts for which the payer and payee hold accounts in the same bank and could allow more clearing to take place internally. This situation could decrease both the number of wire transfers required to transfer funds between banks in the same holding company—a potential benefit for the consumer waiting for funds as well as for the bank—and the amount of image item processing and paperwork in the banking system.

For the largest banking companies, several of the regulatory reforms included in FDICIA could also increase the cost savings associated with interstate branching. Although the act allows many of the auditing and management reforms that apply to insured banks to be met at the holding company level, this option does not apply to bank subsidiaries with total assets of \$9 billion or more or to bank subsidiaries with total assets of more than \$5 billion that do not receive high supervisory ratings.

In each of these cases, bank subsidiaries must submit an annual report on financial condition and management to appropriate regulators and prepare financial statements. The bank's independent public accountant is required to attest to and report separately on management assertions related to its internal controls as well as review bank compliance with governing laws and regulations. Each of these banks must also have its own independent audit committee. FDICIA requirements for independent audits of financial statements, however, may be satisfied at the holding company level for any insured bank subsidiary regardless of asset size.

At the present time, only a handful of subsidiary banks would have to maintain independent controls, but the number could increase if interstate banking were enacted and bank size grew.

⁷It is difficult to shift capital among banks within a holding company. To do so, a bank must pay a special dividend to the holding company—sometimes requiring regulatory approval—which in turn must invest the funds as capital in the bank that required the capital. This complicated process must be followed whenever credit demands shift among a holding company's bank subsidiaries.

Under the current system, if one bank borrows funds from another bank in its holding company, the bank lending the funds must hold capital against the loan, while the bank borrowing the funds must also hold capital against the assets purchased with the funds.

Achievement of Benefits in a Market Economy Is Uncertain

The potential benefits we described represent opportunities that could help banking companies become healthier. However, nothing is automatic about the ability of any particular bank to realize such benefits. A bank's ability to take advantage of the opportunities that interstate banking or branching would make available would depend on the decisions it makes and on market conditions. It would also depend on how constrained the bank is by current laws and regulations. As a result of market competition, many of the potential benefits can ultimately accrue to the public (in the form of lower prices) or to the owners of acquired institutions (who were paid premiums for their institutions). In addition, some banks may do poorly in the face of additional competition.

Net Impact on Bank Profitability in Competitive Markets Is Hard to Gauge

As we have pointed out, interstate banking will open up opportunities for diversification and cost savings. However, these benefits cannot be viewed in isolation. Offsetting effects on revenues or other items that affect the profitability and soundness of the bank must also be considered. Such interrelationships make it harder to generalize about how liberalized interstate banking laws will influence the health of any particular company.

Interstate banking will improve bank profitability if revenues increase or expenses decrease without any offsetting effects. (See table 4.2 for the main elements of banking revenues and expenses.) Depending on how well an institution is managed or the nature of the competitive environment within which the bank is operating, potential offsetting effects could occur. For example, if a bank were to cut costs by reducing the staff responsible for making loans, the savings could be more than offset by increased loan losses from poor lending decisions. On the other hand, higher costs could be offset by the increased revenues for which the added expense might be responsible. For instance, while increasing bank services could raise noninterest expenses, these costs could be offset by higher noninterest revenues from the additional business these services attract.

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Table 4.2: Bank Revenues and Expenses

Dollars in billions		
	Amounts	Totals ^a
Revenue		
Interest	\$255.3	
Noninterest	65.6	
Subtotal		\$321.0
Expenses		
Interest	121.9	
Noninterest	130.9	
Provision for loan losses	25.9	
Subtotal		278.6
Net income^b		\$42.4

Note: Data are for the period ending December 31, 1992.

^aTotals may not add due to rounding.

^bNet income before taxes and extraordinary items and securities gains/losses.

Source: FDIC Quarterly Banking Profile data.

Other benefits are ascribed to interstate branching rather than interstate banking. Some bankers told us that the need to maintain separate bank legal structures because interstate branching is not permitted increases not just the cost but also the risks of interstate expansion. Presidents and boards of directors of separate subsidiary banks, for example, may maintain their own credit cultures rather than adopt that of the parent company, which could result in increased loan losses. Fraud may also cause higher losses in a more complicated holding company structure in which some functions are duplicated. However, such benefits are difficult to verify quantitatively.

Other banking companies have given us a different opinion, telling us that the revenue benefits of a bank subsidiary structure far outweigh the added costs. Separate bank subsidiaries are believed to maintain customer loyalty, and subsidiary boards of directors are thought to be a source of referrals for loans and other business. It is also possible that separate subsidiaries contribute to loan quality if local expertise is brought into the loan review process. Separate and smaller loan limits for bank subsidiaries may also prevent a single bad loan decision from jeopardizing the entire company. If separate subsidiaries do result in better quality lending, the potential contribution to profitability could be quite significant.

Ultimately, the market will decide which banking structure is more suitable for the business strategies being pursued by individual banking companies. Given banks' experience with in-state branching, it is likely that both forms of organization will survive under interstate branching.

The importance of management decisions and market forces is also evident in pricing that affects both revenues (loan rates) and expenses (rates offered on deposits and other liabilities). Some have suggested that one of the benefits of nationwide banking and the additional consolidation it might bring is that pricing in some markets might become more rational—in other words, more reflective of the risk incurred in making loans or accepting deposits.⁸ To the extent that banks (and thrifts) have suffered from overcapacity, which is reflected in too many deposits chasing too few good loans, they may not have priced loans to sufficiently compensate for the risks involved in lending. The high deposit rates paid by weaker institutions that sought to generate a flow of cash to keep them afloat also may have forced healthy banks to offer excessively high rates in order to compete.⁹ The combination of uncertainty about asset quality and high deposit rates that characterized markets with weaker institutions is likely to have reduced the profitability of even the healthier banks. If interstate banking and branching contributes to the process of consolidation by eliminating weaker institutions, the industry may return sooner to more stable pricing.

On the other hand, the dynamics of pricing in competitive markets can result in pricing that reduces bank profitability, at least in the short term. This would occur if banks price aggressively in attempts to gain or hold market share. Although such an action may be necessary to ensure an institution's viability or survival over the long term, in the short term this could mean that any savings from interstate banking and branching may be redistributed to the general public in the form of higher deposit rates, lower loan rates or fees, or additional services.

Another factor to consider in assessing the net impact of interstate mergers on the financial health of an acquiring institution is the price that

⁸Rational pricing should not be confused with monopoly or oligopoly pricing that is possible if mergers result in market power. Antitrust policy is designed to ensure that market power is not attained, as we discuss in chapter 7.

⁹A study of the deposit market in Texas illustrates the problem of irrational pricing. The study found that during the mid-1980s deposit rates were higher in Texas than elsewhere in the country, even in banks that were well capitalized. The study attributed this to the effects of poorly capitalized thrifts that drove up rates in their efforts to remain liquid. Short, Genie D., and Jeffrey W. Gunther, "The Texas Thrift Situation: Implications for the Texas Industry." *Financial Industry Studies*, Federal Reserve Bank of Dallas (Sept. 1988), pp. 1-11.

the institution pays for the bank it is acquiring. If the value of all estimated future savings resulting from an interstate merger were capitalized into the price paid to the stockholders of the acquired bank, they, rather than the acquiring bank, would be the main beneficiaries of the cost savings. Cost savings or other gains from liberalized interstate banking laws may also be paid to shareholders of the acquiring institution in the form of higher dividends and therefore may not be available to help make additional loans or finance other bank services.

Once all of the market dynamics are considered, it becomes apparent that management capability is the most important factor that will determine how liberalized interstate banking and branching laws will affect the health of individual banking companies. To illustrate, some of the most profitable of the large banking companies in the country have noninterest expenses (as a percentage of assets) that exceed the industry average; their profitability stems from a combination of high net interest margins, low loan losses, or high noninterest income. It is the overall response to competition, not the achievement of predetermined benefits in a particular category such as noninterest expenses, that will determine which banks get healthier and which do not.

Evidence on Cost Savings From Past Mergers

To gain greater insight into how consolidation associated with changes in interstate banking laws could affect the health of banks, we reviewed several studies of past mergers. These studies investigated the extent to which mergers have resulted in cost savings. The results of these studies generally support the contention that cost savings and efficiency benefits cannot be taken for granted but depend on bank management's ability to realize them. The studies found the following:

- Neither the profitability nor the efficiency of 413 banks acquired between 1968 and 1978 improved more than the profitability and efficiency of banks not involved in mergers.¹⁰
- In 47 bank mergers in New England from 1982 to 1987, merging banks did not achieve significant improvements in operating profits compared with other banks in New England in the 2-year period after their merger. Mergers of newly acquired banks did result in reductions in the growth of

¹⁰Rhoades, Stephen A., "The Operating Performance of Acquired Firms in Banking Before and After Acquisition," Staff Paper No. 149. Board of Governors of the Federal Reserve System. April 1986.

noninterest expenses, but because assets also declined the cost savings did not result in increased operating profits.¹¹

- In 11 New England mergers that took place between 1982 and 1987 involving banking companies with more than \$1 billion in assets and 30 percent of their deposits in the same market, no apparent systematic profitability or efficiency gains were realized.¹²
- On the basis of 240 merger transactions between 1982 and 1986 in which the target and the acquiring banking company each had \$100 million or more in assets at the time of the merger, a study concluded that there is no evidence of significant cost savings from bank mergers.¹³ A related study using the same data found that while the merging banks experienced a decline in costs during the third and fourth postmerger years, the decline was not significantly different from industry trends.¹⁴

Some industry analysts, while not questioning the results of these studies, do dispute their implications for more recent and future mergers. They believe that geographic expansion, not cost savings, was the major goal of the mergers that these studies analyzed. Consequently, they are concerned that results from the studies cited above are not representative of more recent mergers or relevant for future mergers, which are expected to focus on cost savings. Some believe that merger cost savings equal to about one-third of the noninterest expenses of acquired institutions are possible.

Sufficient time has not elapsed after the most recent large bank holding company mergers to enable one to draw conclusions about their ultimate impact on the banks' bottom lines or the relevance of the studies described above to these mergers. Yet bank analysts have projected that 23 to 32 percent of the acquired institutions' noninterest expenses would be saved in several of these mergers.¹⁵ The estimates are based on the merger plans of the institutions involved and the belief that economies of

¹¹Linder, Jane C., and Dwight B. Crane, "Bank Mergers: Integration and Profitability." Working Paper No. 91-038, Harvard Business School, 1991.

¹²Rhoades, Stephen, "Large Horizontal Bank Mergers and Operating Performance," Board of Governors of the Federal Reserve System, November 1990.

¹³Srinivasan, Aruna, and Larry Wall, "Cost Savings Associated with Bank Mergers," Working Paper 92-2, Federal Reserve Bank of Atlanta. February 1992, pp. 1-26.

¹⁴Srinivasan, Aruna, "Are There Cost Savings from Bank Mergers?" *Economic Review*, Federal Reserve Bank of Atlanta. March/April 1992, pp. 17-28.

¹⁵These estimates would not necessarily be inconsistent with the results of the studies focusing on the efficiency benefits of mergers because these studies focus on bank costs in relation to bank assets. Costs may, therefore, be cut by these amounts, yet whether gains in efficiency result from the mergers will depend on whether costs decline in relation to assets. Differences in conclusions about the effects of mergers may simply reflect these different measures.

scale are possible in certain areas of banking. The estimates have been raised or affirmed in the past months on the basis of successful cost savings to date. For example, the merger between BankAmerica and Security Pacific, which analysts originally predicted would save as much as \$1.2 billion per year after 3 years, is now estimated to save \$1.5 billion per year, also after 3 years. By the end of 1992, the merger between Chemical and Manufacturers Hanover produced \$60 million more in cost savings than the initial \$220 million projection. Analysts also believe that the NCNB and C&S/Sovran merger that formed NationsBank is well on its way to achieving the \$450 million in cost savings projected by 1994. Although two of these mergers—NCNB/C&S Sovran and BankAmerica/Security Pacific—involved significant operations in multiple states, the majority of the cost savings have been attributed to the elimination of overlapping branches or staff reductions. Such savings would be harder to achieve in mergers between banking companies that operate in completely different markets.

Risks to BIF

In the long run, if the overall health of the industry improves, BIF will be better off. However, because the costs to BIF are associated with the portion of the industry that is in danger of failing, it is also necessary to assess the impact of the liberalization of interstate banking and branching laws on the portion of the industry that is least likely to do well. Although the condition and performance of the banking industry improved substantially in 1992, by December 31, 1992, a significant portion of the industry—accounting for about 12 percent of industry assets—was on FDIC's problem bank list. The effect of liberalizing interstate banking laws on this portion of the industry, as well as on risk-taking by larger banking companies, should be of particular concern to BIF.

BIF's Exposure to Problems in Large Banks Is a Key Issue

As we discussed in chapter 3, nationwide banking and branching are likely to result in an increase in the proportion of banking system assets in larger, more geographically diversified banking companies. This could benefit BIF since FDIC has lost more money per dollar of deposits insuring the deposits of smaller banks than larger ones. From 1985 through 1991, institutions with less than \$1 billion in assets accounted for 59 percent of BIF losses. On average, those institutions hold less than 50 percent of insured bank deposits.

However, individual large bank failures pose by far the greater risk to BIF because of the potentially great demands each one can place on BIF's

resources. Until BIF builds up adequate reserves, its resources could be strained in financing the resolution of a single, very large failed banking company.

Although most bank failures have occurred among smaller banks, large banks have experienced problems in controlling risks. The largest banks as a group were the least profitable during the 1985 to 1992 period, primarily as a result of high loan losses. Regulators have also expressed reservations about the ability of rapidly growing companies to develop the systems necessary to manage risks effectively. Managing risks effectively can be a particular problem if banking companies make acquisitions in haste without a well-developed or well-managed plan of expansion. Therefore, if interstate expansion were to foster growth that is too rapid or create companies that are too large to manage their risks effectively, difficulties in controlling risk could increase.

While many industry experts with whom we have spoken believe that interstate bank expansion has progressed smoothly, there have been some notable exceptions. Bank of New England, for example, used its ability to expand throughout New England to make several large acquisitions, some of which analysts perceived to be extremely overpriced. High acquisition prices fostered the need for even more growth in an effort for the Bank of New England to more quickly recoup the acquisition costs. Management's inability to control the risks associated with this growth was believed to have been a major cause of the Bank of New England's failure. While rapid growth is possible without interstate banking and has characterized numerous failed banking companies that have not expanded interstate, it is questionable whether the Bank of New England would have been able to grow as much or as quickly had it not been for interstate banking.

Some weaker, large banking companies may also be put under more pressure by the added competition that could result from interstate banking. The need to reduce margins to improve competitiveness may impair profitability, particularly for inefficient companies. Unless these banking companies improve their operations—or are acquired by healthy institutions—desperate efforts to compete may damage their safety and soundness, possibly leading to failure. In the short run, measures adopted by weak banking companies may also affect the profitability of stronger institutions that may be forced to cut loan rates or increase deposit rates to remain competitive.¹⁶

¹⁶In the long run, the public and the banking industry as a whole benefit by the elimination or acquisition of inefficient banking organizations. To the extent that the industry becomes more efficient, the industry should be better able to compete against other financial services providers.

**Risks to BIF From
Interstate Banking Are
Similar to Those Under
Existing Laws**

Many of the risks associated with liberalized interstate banking also exist as a result of the consolidation that is possible under existing laws. For example, rapid growth in bank assets led to many problems in the 1980s, often in states where interstate banking or even in-state branching was not allowed. Consequently, we believe that it makes sense to concentrate on the general ability of the regulatory system to handle the types of risks that are associated with both interstate banking and consolidation. If the regulatory framework is adequate, these risks should be manageable.

Conclusions

Nationwide banking and branching will provide opportunities for individual banking companies and the banking system as a whole to benefit. Banking companies may be able to become stronger by enhancing the geographic diversification of their assets and liabilities through both interstate banking and branching and by lowering the cost of their operations as a result of a simplified banking structure permitted by interstate branching. If these benefits are realized, BIF's condition would improve.

Yet the magnitude of these benefits and whether they will improve a banking company's bottom line will depend largely on individual bank management. Furthermore, the potential improvements to the health of the industry do not reduce the importance of good supervision to protect BIF from failures caused by an inability of some banking companies to compete, as well as from any unmanageable risk-taking, as we discuss in the following chapter.

The difficulty in predicting exactly how bank managers will respond to a change in the law and the potential risks associated with change are not sufficient reasons to refrain from adopting a nationwide banking and branching law. It is reasonable to allow market forces to determine the structure of the banking industry and the distribution of benefits from interstate banking and branching, as long as solid regulation is in place to protect BIF and taxpayers.

Regulatory and Supervisory Measures Needed to Control Risks to Industry Safety and Soundness

Chapter Summary

Topic	Principal Findings	
<p>This chapter examines the role regulation and supervision can play in protecting against potential safety and soundness risks associated with interstate banking and branching. It also discusses supervision issues associated with larger banking companies most active in interstate expansion.</p>	<p>If larger banking companies are to be given additional opportunities for interstate expansion, it becomes even more important that these companies be well capitalized, managed, and supervised.</p>	<p>Permitting interstate banking and branching for well-capitalized, well-managed banks could potentially benefit regulation and BIF by</p> <ul style="list-style-type: none"> • simplifying the corporate structures of banking companies thereby reducing the number of differently chartered bank subsidiaries and making it easier for risk-management systems for a company as a whole and • creating a larger pool of acquirors for weak and failing banks.
	<p>Improved supervision together with proper implementation and enforcement of the early closure and other safety and soundness provisions in FDICIA are vital steps to ensure that additional industry consolidation and the potential risks associated with nationwide banking and branching do not strain BIF's resources.</p>	

Many of the measures that are needed to protect BIF against safety and soundness risks can be addressed through the use of current regulatory authority. Requirements that banks be well capitalized and well managed are of particular importance to safe and sound interstate expansion. However, improvements are needed to make regulatory arrangements more effective. These improvements include the implementation of the regulatory and accounting provisions of FDICIA relating to capital valuation and prompt corrective action. They also include eliminating weaknesses in the examination process, which we have identified in previous reports, that also raise concerns about the merger approval process because examination reports are reviewed as part of the merger approval process.

The removal of interstate branching laws could make the examination and inspection of interstate bank holding companies more efficient and potentially more effective if these companies simplify their structures by converting interstate bank subsidiaries into interstate branches. In turn, more efficient examinations could be less burdensome for banking companies.

Nationwide banking and branching could also benefit BIF by increasing the pool of bidders for some failed banks, making the acquisition of others more attractive, and encouraging the acquisition of weak banks before

they fail. More acquisitions of weak banks would serve to make FDICIA's prompt corrective action provision more effective.

Good Supervision and Implementation of FDICIA Reforms Are Needed to Minimize BIF's Exposure to Losses

We believe that improvements to bank regulation and supervision are needed to minimize BIF's exposure to losses. FDICIA contains most of the changes that required legislation.

Strong Capitalization and Management Are Important to Safe and Sound Interstate Expansion

One of the key protections for BIF is the requirement that expanding institutions have adequate capital. The policies of the Federal Reserve and the other regulatory agencies recognize this; they generally require that banking companies be well capitalized to undertake mergers.¹ Although there are no specific requirements defining the minimum capital ratios one bank must have in order to acquire another, the Federal Reserve said it generally uses the definition of well capitalized that FDICIA required regulators to develop.² In addition, the Federal Reserve requires that premerger book value capital ratios of acquiring bank holding companies and their bank subsidiaries be maintained after mergers are consummated.³ The Federal Reserve pointed out, however, that acquisitions of problem banks may merit making exceptions to this rule on a case-by-case basis.

The capital criteria and the way they have been applied appear to have been sufficient for ensuring that relatively weakly capitalized banking

¹Although, all three of the federal bank regulators (the Federal Reserve, FDIC, and OCC) and some state bank regulators may become involved in interstate mergers, this chapter focuses on the Federal Reserve. The Federal Reserve is primarily responsible for approving interstate mergers because such mergers must be conducted through bank holding companies.

The convenience and needs and antitrust criteria evaluated in the merger process are discussed in chapters 6 and 7, respectively.

²Under this definition, a well-capitalized bank must have (1) a tier 1 risk-based capital ratio of greater than 6 percent, (2) a total risk-based capital ratio of greater than 10 percent, and (3) a leverage ratio of 5 or more percent. (The leverage ratio approximately corresponds to the book value of equity divided by total assets.)

³Goodwill and other intangible assets are not counted toward capital calculations. If a bank has unusually high capital ratios before a merger (and there are no risk factors that especially warrant such ratios), regulators said that they would not necessarily insist that the capital ratios after the merger equal the premerger ratios.

companies have not increased their leverage through mergers. We reviewed the approvals of five of the largest bank holding company mergers that did not involve failed institutions and determined that the requirement that capital levels be maintained was adhered to in all cases.⁴ Perhaps as a result of these merger criteria, weakly capitalized large bank holding companies have experienced slow growth—or no growth at all—relative to the 50 largest banking companies over the past several years.⁵

Prompt Corrective Action and Other FDICIA Reforms

If large banking companies are to be given additional opportunities for interstate expansion, it becomes even more important that these companies be well supervised, capitalized, and managed. In order to protect BIF, it is also imperative that regulators act quickly to deal with problems that arise.

The prompt corrective action provisions of FDICIA to address concerns such as these by ensuring that if an institution fails to operate in a safe and sound manner, it will be subject to timely and forceful supervisory responses, including prompt closure. The provisions give weak banking companies strong incentives to either recapitalize or be acquired while they still have some value. If implemented effectively, the provisions should be adequate to ensure that large, complex banking companies—including those that operate interstate—are well capitalized and well managed and that they have incentives to operate safely and soundly.

In the past, relying on book value capital as a measure of financial strength has proven problematic because the accounting rules that were used to define capital gave institutions too much flexibility in deciding how to value problem assets. Consequently, capital problems were generally a lagging indicator of a banking company's financial difficulties. FDICIA's accounting reforms concerning the valuation of assets will improve the reliability of capital ratios once the reforms are implemented.⁶

⁴In four of the five cases, capital levels of the consolidated entity were above regulatory requirements at the time of the merger. These mergers were BankAmerica/Security Pacific, Society/Ameritrust, Comerica/Manufacturers National, and First Union/Florida National. However, in the merger of Chemical Bank and Manufacturers Hanover, the merger was approved by the Board of Governors of the Federal Reserve with the understanding that the required amount of capital would be raised immediately following the merger. This condition was met.

⁶Large bank holding companies also tended to have market value of capital that was below book value, indicating that financial markets believed that their economic value was less than the net worth shown on their books.

⁵See FDICIA, section 121(a).

Even with these accounting improvements, capital ratios will need to be supplemented by other measures of management capability because high capital levels in times of economic growth can mask risk management problems, which could prove damaging if the economy were to weaken. The thorough evaluation of management capability would include reviews of internal controls and management's understanding of the target company's operations and recognition of its loan portfolio problems. The management and supervisory reforms contained in FDICIA provide a sounder basis for determining the capability of management to handle the larger companies that will likely be created under more liberalized interstate banking laws.⁷

Examination of Large,
Complex Banking
Companies Needs to Be
Improved

As banking companies become larger and more complex, it is less likely that regulators will be able to monitor all of their activities. To compensate, regulators must place more reliance on evaluating internal controls.⁸ If regulators are unable to or do not adequately assess internal controls, it is likely that they will not have a true understanding of management's ability to monitor and control the risk-taking within the banking company as a whole. Problems that could lead to serious financial difficulties might, as a result, go undetected.

In previous reports, we have found that examiners did not systematically identify, test, and evaluate critical internal controls to determine how well they were functioning.⁹ Even when examiners found internal control weaknesses, these weaknesses often were not recognized as early warnings of financial problems. Overall, there was no evidence that examiners conducted comprehensive reviews of internal controls or acted upon deficiencies when they were found. This places the reliability of the supervisory process—particularly with respect to larger banking companies—in some question.

Our questions about the effectiveness of the bank examination and the bank holding company inspection processes also raise concerns about the merger approval process because regulators rely primarily on previous examinations and inspections to evaluate the parties involved in a merger.

⁷See FDICIA, sections 112, 111, and 132.

⁸Internal controls include the bank's plan of organization and all methods and measures adopted by the bank to safeguard its assets, ensure the accuracy and reliability of accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

⁹See, for example, Bank and Thrift Regulation: Improvements Needed in Examination Quality and Regulatory Structure (GAO/AFMD-93-15, Feb. 16, 1993).

Even though the Federal Reserve is responsible for approving bank holding company mergers, the supervisory weaknesses of all the bank regulators are a concern because the examinations of any of the federal bank regulators may be used in evaluating the banks and bank holding companies involved in a merger.¹⁰

Liberalized Interstate Banking and Branching Laws Can Help BIF and Make Supervision More Effective and Less Burdensome

Nationwide banking and branching laws can benefit BIF by making it easier to resolve problem banks. Nationwide branching could also make supervision more effective and less burdensome by simplifying the corporate structures of banking companies. Simplifying the corporate structure, however, will not necessarily eliminate the potential problems associated with divided regulatory responsibility for banks and their holding companies.

Reduced Costs to BIF

Although we cannot quantify the benefits, we believe that removing geographic restrictions on interstate banking and branching could benefit BIF by (1) reducing failures if more failing banking companies are acquired interstate, (2) making the acquisition of some failed banks more attractive if they can be converted into interstate branches of the acquiring institution, and (3) increasing the pool of bidders for smaller failed banks.

Until the early 1980s, failed banks could only be purchased by banks within their own state, greatly limiting the pool of potential bidders for these banks and potentially increasing the cost of resolutions to FDIC. In 1982, the Garn-St Germain Act (subsequently expanded upon by the Competitive Equality Banking Act of 1987 and other legislation) amended section 13 of the Federal Deposit Insurance Act to permit banking companies from any state to acquire failed banks with over \$500 million in assets anywhere in the country, notwithstanding the Douglas Amendment. Section 13(f) of the act currently authorizes acquisitions of both banks in default and banks in danger of default; however, interstate restrictions still apply to the purchase of banks with assets of less than \$500 million.

Interstate banking could solve another problem that arises from the fact that section 13(f) of the Federal Deposit Insurance Act, as outlined above, does not apply until a bank is in default or in danger of default. The purchase of other troubled or failing banks remains restricted by state

¹⁰We focus on the Federal Reserve because all interstate mergers involve bank holding companies. In-state bank mergers are reviewed by the supervisory agency responsible for the acquiring bank.

interstate banking laws. Again, these geographic restrictions can increase BIF's costs. As FDICIA's early closure requirements increase the incentives for troubled banks to seek merger partners before they fail, interstate restrictions that hinder potential acquisitions may become increasingly costly. Nationwide banking could help troubled banking companies find merger partners and could ultimately reduce the costs to BIF if these institutions are acquired before they fail. The magnitude of such potential savings depends largely on the acquisition strategies of expanding banking companies.

We agree with FDIC that interstate branching also can make the acquisition of failed and failing banks more attractive. Acquiring banks may be more likely to purchase such banks if they could convert them to interstate branches because many banks believe that branches are less expensive to operate than bank subsidiaries.¹¹ The greater attractiveness of failed banks would not only reduce the cost of bank failures to BIF but could also benefit local communities to the extent that a banking presence would be maintained as branches of the acquiring bank when the failed bank otherwise would have been dissolved.

Interstate Branching Can Streamline Bank Supervision and Reduce Regulatory Burden by Simplifying the Corporate Structure

Interstate banking has increased the complexity of banking companies because, under the Douglas Amendment, only holding companies with separate subsidiary banks may expand interstate. If the liberalization of interstate branching laws were to encourage banking companies to simplify their structures by converting bank subsidiaries into interstate branches, it could reduce the number of regulatory agencies responsible for each banking company and make the examination and inspection of larger banking companies more efficient and potentially more effective by enabling examiners to more easily assess risks for the company as a whole. This, in turn, would help reduce the burden of multiple regulatory examinations on banking companies.

Less Need for Interagency Coordination

Under the current regulatory structure, all bank holding companies and their nonbank subsidiaries are regulated and inspected by the Federal Reserve. Supervision of the holding company's bank subsidiaries is shared among the three federal regulatory agencies and the 50 state banking

¹¹Perpetual Federal Savings Bank has been cited as a failed institution that might have garnered a higher price if interstate branching rather than interstate banking had been an option. Because Perpetual was located in Maryland, Virginia, and the District of Columbia, a bank not already in these markets would have had to establish separate subsidiary banks or maintained a thrift charter to acquire the organization. Some banks felt that this cost was great enough to discourage some potential bidders, thereby reducing the price obtained by BIF for Perpetual.

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and Soundness

departments. The agency or agencies responsible for each bank is determined by the bank's charter. OCC supervises national banks. FDIC shares the supervision of state-chartered, non-Federal Reserve member banks with the state banking departments, and the Federal Reserve shares supervision of state-chartered member banks with the state banking departments.

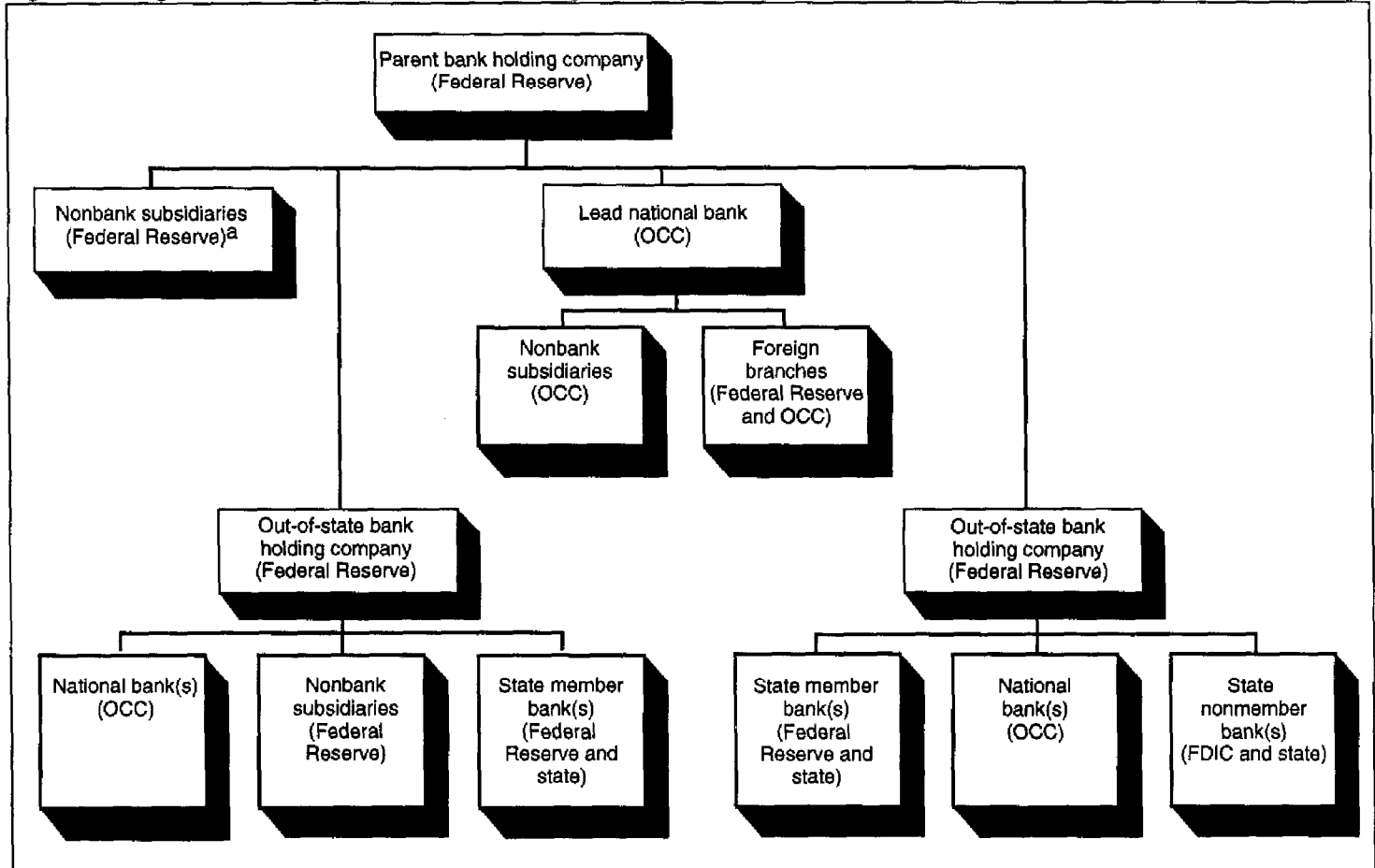
As a result of this regulatory division of responsibility, a bank holding company and its bank subsidiaries may require supervision and examination by all three federal bank regulators and by numerous state bank regulators.¹² Of the 33 bank holding companies that currently own banks in 4 or more states, 16 face annual examinations of their bank subsidiaries by all 3 federal bank regulators.¹³ Figure 5.1 illustrates the complexity of the regulation of a bank holding company.

¹²See appendix III for additional information on holding company supervision.

¹³This occurs when the bank holding company has bank subsidiaries that are national banks under OCC jurisdiction as well as state nonmember banks regulated by FDIC. The Federal Reserve is responsible for state member banks as well as the holding company.

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Figure 5.1: Regulation of a Hypothetical Bank Holding Company



Note: State and federal regulators for each bank are in parentheses.

^aNonbank subsidiaries may also be regulated by other federal and state agencies.

Regulation and supervision of a multistate bank holding company becomes even more complicated if the holding company's subsidiaries are located in several regulatory districts.¹⁴ If, for example, a bank holding company is headquartered in New York and has national bank subsidiaries in New York and Texas, non-Federal Reserve member, state chartered banks in Massachusetts and California, and nonbank subsidiaries in

¹⁴The Federal Reserve System is composed of a Board of Governors and 12 district Federal Reserve Banks located in Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco. FDIC has regional offices in New York, Atlanta, Boston, Chicago, Dallas, Kansas City, Memphis, and San Francisco. OCC has district offices in New York, Atlanta, Chicago, Kansas City, Dallas, and San Francisco.

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Illinois and Florida, it would be regulated and examined by all three federal bank regulators located in seven districts or regions and by two state bank regulators.

Multiple agency examinations and examinations that cover several districts or regions require a significant amount of coordination. The Federal Reserve Bank responsible for a multistate holding company must coordinate with other Federal Reserve Banks if holding company subsidiaries are located in several Federal Reserve districts.¹⁵ The other banking agencies must also coordinate if bank subsidiaries of a single bank holding company are located in several regions. Interagency agreements have been worked out among bank regulators, under the auspices of the Federal Financial Institutions Examination Council, for agencies to coordinate their examination activities in supervising banking companies that have assets in excess of \$1 billion. Working within these agreements, efforts have been made within and among federal regulatory agencies and between federal and state agencies to improve coordination. Such efforts notwithstanding, coordination is difficult, given that these agencies have different regulatory policies and procedures. Similar problems of coordination and communication could develop among state regulators of state-chartered banks if state-chartered banks were to branch interstate.

In this report, we did not attempt to conduct a thorough review of coordination and communication among regulators. However, interviews that we conducted with Federal Reserve officials as well as bank management indicate that improvements in coordination are possible. Bankers tell of having to answer to a number of regulators who are not always consistent in the information they want or in the way regulations are interpreted and applied. Furthermore, federal bank regulators occasionally believe that information they receive from other regulators is not always timely or sufficient to support a merger decision. For example, before approving some of the larger bank holding company mergers, the

¹⁵The location of the top-tier bank holding company determines the location of the Federal Reserve Bank responsible for supervising the entire bank holding company. Except for the largest bank holding companies, the responsible reserve bank coordinates the overall supervision of the bank holding company and determines the frequency of on-site inspections. Federal Reserve staff in Washington, D.C., handle the planning and scheduling of inspections in the largest bank holding companies.

Reserve banks that have subsidiary holding companies, member banks, or nonbanks of the top-tier holding company in their districts are designated as host reserve banks. Responsible reserve banks rely, as much as possible, on host reserve banks to examine the bank holding company subsidiaries in their districts. Some reserve banks maintain a constant on-site presence in the largest, most complex companies. Because most nonbank activities of bank holding companies are centralized, the Federal Reserve can concentrate its examiners at fewer locations.

Federal Reserve has conducted its own examinations of the largest national bank subsidiaries in the holding companies—an indication that it felt that it could not base a merger decision on the information it was obtaining from the banks' regulator.

Interstate branching could reduce the number of banking agencies responsible for a single bank holding company and its subsidiaries if banking companies consolidate their interstate operations into one bank with interstate branches. Such a structure would be examined by only one federal bank regulator, and the bank holding company would be inspected by the Federal Reserve if the bank holding company structure were retained for other purposes.¹⁶ Problems associated with interagency coordination and communication could, thus, be greatly reduced.

Improve the Examination Process

A simplified banking company structure under interstate branching has the potential to improve the bank examination process in several ways. If bank holding companies converted bank subsidiaries into branches, regulatory resources could be concentrated at a bank's headquarters and at any processing facilities where records are kept, instead of being spread among all of a bank holding company's subsidiary banks. Only a sample of branches would need to be examined to assess a bank's compliance with laws, regulations, policies, and procedures.

Even though the asset size of the institution would not change, fewer examiners might be needed. For example, regulators say it is likely that one bank with \$5 billion in assets and centralized systems and numerous branches will not require as many examiners as five \$1 billion bank subsidiaries of a bank holding company. The actual amount of regulatory savings will depend on the degree of centralization of bank policy decisionmaking and lending, the quality of the management information systems, the bank's systems of internal controls, and the risk profile of the banking company.

The consolidation of bank subsidiaries into bank branches would simplify the bank examination process. Under the current bank holding company structure, examinations of bank subsidiaries may be spread out over an entire year. While regulators are not precluded from examining all of a

¹⁶Most larger bank holding companies have nonbank subsidiaries. Consequently, even if these holding companies were to consolidate their bank subsidiaries into one bank with several interstate branches, the holding company structure would still be necessary for the nonbank subsidiaries. Therefore, the Federal Reserve would continue to be involved in bank holding company inspections, even if the bank holding company's subsidiary were a national bank. Bank holding companies wanting to reduce supervision and regulation to only one federal regulator would have to charter their bank subsidiary (or subsidiaries) as state member banks.

holding company's banks simultaneously, such coordination becomes more difficult as the number of regulators involved increases.

In a branch system, all of the branches in the entire banking company could be examined simultaneously. One comprehensive examination would make it easier to obtain a complete picture of the company and would prevent the shifting of problem assets among subsidiaries. The reduction of multiple regulators with varied examination schedules would also reduce the possibility that information about the condition of the banking company will fall through regulatory cracks.

The safety and soundness reforms in FDICIA contain incentives for multibank holding companies to establish centralized systems of management and control. For example, FDICIA's management and auditing reform requirements may be met at the holding company level for well-rated bank subsidiaries with less than \$9 billion in assets. However, this only applies if the systems in place at the holding company are comparable to those that FDICIA requires for each separately insured bank. In addition, in its proposed regulations for another of FDICIA's safety and soundness requirements,¹⁷ the Federal Reserve adopted the same standard for banks and their holding companies. In doing so, it noted that under the proposed regulation, it "believes that a holding company could establish policies for the entire organization, with each of the subsidiary depository institutions affirming these policies."¹⁸

How each of the regulatory agencies would be affected by interstate branching will depend on the extent to which interstate bank holding companies consolidate their bank subsidiaries and the choice of bank charter into which interstate operations are consolidated. It is possible that interstate branching could significantly alter the distribution of bank charters, thereby requiring a shift of regulatory responsibilities among the federal and state regulatory agencies. For example, if many banking companies consolidated their interstate bank subsidiaries into a national bank, OCC would be responsible for more bank assets, even though the number of banks it would examine might actually decrease.

To date, interstate banking has already produced some shifts in regulatory responsibility because some bank holding companies have switched to national charters for their bank subsidiaries to simplify regulatory

¹⁷Section 132 of FDICIA.

¹⁸Notice of Proposed Rulemaking for Safety and Soundness Standards, (Section 132 of FDICIA), Staff Memo to the Board of Governors, April 19, 1993, p. 31.

compliance. Federal regulators acknowledged this potential for changes in resource requirements among the regulators. In general, however, they did not believe that interstate branching would complicate the regulatory process; consequently, they have not developed plans for responding to the changes that nationwide banking and branching could bring, such as an increased need for intra-agency coordination among regulatory districts or regions in which interstate branches or regional processing centers are located.

**Divided Responsibility for
Holding Company and
Bank Examinations
Complicates Supervision
and Regulatory
Compliance**

Under the existing regulatory structure, divided responsibility for supervising the holding companies and their bank subsidiaries would continue even if all bank subsidiaries were consolidated into branches.¹⁹ Of the 190 banking companies with interstate bank subsidiaries, about 52 percent have lead banks that are national banks supervised by OCC. Another 33 percent have lead banks that are state-chartered, nonmember banks supervised by FDIC. As a result, the bank holding company would be regulated and supervised by the Federal Reserve, while the lead bank would be under the jurisdiction of a different federal regulator.

This division of responsibility increases the chances that important information will not be shared among regulators. For example, sections 23A and 23B of the Federal Reserve Act place a number of limitations on transactions between a bank and other parts of the holding company. The purpose of these limitations is to keep transactions from weakening the bank and increasing the risks to BIF. Because there are two sides to such a transaction—the bank holding company and the bank—and a different regulator is generally responsible for each side, it is relatively easy for violations to be overlooked. We recently reviewed holding company inspections and generally found problems with supervision of intercompany transactions and found evidence that the regulatory division of responsibility contributed to this problem.²⁰

From our interviews with market participants and regulatory officials, it is clear that most banking companies centrally manage their exposure to

¹⁹The single exception would be in the case of a holding company that owned banks that were all state member banks. In this instance, the Federal Reserve would be the federal regulator responsible for both the banks and the holding company.

²⁰See *Bank Examination Quality: FRB Examinations and Inspections Do Not Fully Assess Bank Safety and Soundness* (GAO/AFMD-93-13, Feb. 16, 1993), p. 45. In one instance cited in that report, an examiner told us that he did not focus on intercompany transactions during the inspection of a large holding company because he relied on the examiner of the lead bank to discover and inform him of any adverse intercompany transactions during the examination. However, during the year in question the regulator of this holding company's lead bank did not review insider and affiliate transactions.

risk. For example, although a banking company may conduct trading activities from a number of entities within the corporate structure, any large well-managed bank holding company operating in today's competitive environment needs to have a management system that consolidates the risk position of the company as a whole.

This being the case, it makes sense to consolidate regulatory responsibility for assessing the risk management system for the company as a whole. The division of responsibility for holding company inspections and bank examinations can be eliminated in one of three ways. The agencies themselves could be consolidated, one regulator could be assigned to regulate all bank holding companies and all of their subsidiaries, or the holding companies could be divided among or between bank regulators. A proposal by some banking industry experts to give the Federal Reserve regulatory responsibility of the largest bank holding companies because of its role in monitoring the nation's money supply and its experience in regulating foreign bank operations in the United States is just one example of how holding company regulation could be consolidated. Legislation would be required to affect any of these options.

Conclusions

Interstate banking and branching has ramifications for bank regulation and supervision that are both positive and negative. Most of the potential risks—those associated with rapid growth, excessive risk-taking, and poor management, particularly of large banking companies—are relevant to industry consolidation in general. While some of our previous reports have identified regulatory weaknesses, the implementation of prompt corrective action and other FDICIA reforms provide a framework for controlling the risks that additional interstate banking might bring.

Liberalizing interstate banking and branching laws may reduce costs to BIF by making it easier and more attractive to acquire failed and weak banking companies. In addition, by simplifying bank corporate structures, interstate branching could help make supervision more effective and less burdensome. If the remaining restrictions on interstate banking and branching are removed, only well-managed and well-capitalized banks should be allowed to expand. In addition, the major safety and soundness reforms of FDICIA must be implemented properly and be working effectively. These issues are of concern even if Congress chooses not to liberalize federal interstate banking and branching laws because of the consolidation that is already taking place in the banking industry.

Impact on the Economy

Chapter Summary

Topic	Principal Findings
<p>This chapter addresses the effect that removing interstate banking and branching restrictions could have on the nation's economy, particularly on bank customers.</p>	<p>Many bank customers—commercial and retail—could potentially benefit from interstate banking and branching as a result of</p> <ul style="list-style-type: none"> • the wider range of products and services associated with larger banking companies, • likely to result when banks of different size compete for customers, and • the reduced need to maintain separate accounts in different states. <p>However, nationwide banking and branching will probably not benefit all bank customers or all communities. Some communities and small businesses could experience some disruptions when local banks are acquired. To help preempt such potential problems, it is important to have vigilant antitrust enforcement and to make sure that the burden of regulation on small and newly chartered banks is not excessive relative to the risks in such banks.</p> <p>Also, unless community reinvestment reporting requirements are modified, interstate branching may make it more difficult to assess a bank's community reinvestment record.</p>

Many banking services that are not directly available through local banks are available through correspondent banking relationships or through direct solicitations from large banking companies that are outside the local market. Nevertheless, additional competition among banks of varying sizes and business strategies associated with nationwide banking and branching has the potential to benefit the U.S. economy in a number of ways. It could enhance customer convenience, the availability and accessibility of banking services (particularly for some segments of the small business community), and potentially reduce the cost of some services. Local communities could benefit from the more stable presence of larger, more diversified interstate banking companies. The realization of these benefits depends to a great extent on bank management and the degree to which current legal and regulatory constraints impede expansion.

Not everyone will be better off as a result of structural changes in the banking industry. The failure of larger banks created through interstate banking and branching could have a disruptive effect on local communities. Some local borrowers may find it more difficult to access bank credit if banking companies find more profitable lending

opportunities out of state. Furthermore, some small businesses that do not fit into standardized credit scoring categories may find it more difficult to obtain loans.

Regulatory action to ensure that markets remain competitive and that excessive regulation does not discourage new bank charters or the operation of small banking companies is important for the benefits of nationwide banking and branching to be realized and to minimize any adverse effects that liberalized interstate banking laws might have. In addition, strong enforcement of FDICIA's regulatory reforms will reduce the likelihood of disruptive bank failures. Although we have concerns in these areas, there is no reason to conclude that additional legislation is required to resolve them. However, because the full impact of consolidation is not predictable, it is possible that some additional regulatory authority may be required at some point in the future to address any unanticipated consequences of consolidation.

We found no evidence to conclude that nationwide banking and branching will have either a significantly positive or negative effect on service to underserved urban communities.

Increased Competition Can Be Expected to Provide Potential Benefits to the Public

By opening markets to new participants, nationwide banking and branching can be expected to foster more competition in the banking industry.¹ This competition may be due to new entry into protected markets or simply result from increased pressure on banking companies across the country to become more competitive rather than risk losing customers to banking companies from other states. If banking markets function properly, this additional competition has the potential to bring service and price benefits to the public. However, as we noted in chapter 1, data limitations and the inability to predict bank management strategies circumscribe efforts to evaluate these benefits.

One of the most obvious potential benefits from liberalized interstate banking and branching is improved customer convenience. Interstate branching restrictions limit the deposit services banking companies may offer their business customers and individuals in other states, even states in which the banks have a physical presence. For example, a Virginia bank may not accept the deposit of a customer of its Maryland or District of Columbia affiliate. It could do so if these affiliates were converted into

¹It should be noted that no local U.S. banking market is free from potential entry from banking organizations located outside that local market.

branches under interstate branching. Mechanisms such as traveler's checks, bank-by-mail, direct deposit, and ATM networks only partially overcome these service limitations.

About one-quarter of the U.S. population lives in metropolitan areas that include more than one state and therefore would be most likely to benefit from the convenience of interstate branching. In addition, small or medium-sized businesses that operate across state lines, business travelers and tourists, college students, and individuals who spend part of the year in more than one state could avoid the cost and inconvenience of opening or maintaining separate accounts for each state they frequent.

Interstate banking will also provide many bank customers, both businesses and individuals, with more choices of banks of different sizes to service their banking needs. This variety of banking companies will help ensure that the greatest range of banking needs is met. Larger banking companies—those that are most likely to expand interstate—generally offer a wider array of products and services than smaller banks because they can generate the volume of business necessary to justify such services. Liberalized interstate banking consequently may increase the availability of such products and services.² Community banks are preferred by many bank customers because of the perception that they offer more personal service, particularly to customers with unconventional credit or service needs. These banks have demonstrated an ability to hold their own in competition with larger banks, as we discussed in chapter 3.

If markets are competitive, consumers also benefit as banks compete by offering services at lower prices. Indeed, many of the cost savings associated with interstate branching that we discussed in chapter 4 may benefit the bank customer, not the banking company, because the cost savings may be passed along to customers as banks compete to increase or maintain their market share. A number of factors can affect the price of particular banking services, including labor costs, local economic conditions, the nature of the competition, and the general business

²Mutual fund sales is one example of the type of service that might become more available through banking companies as a result of interstate banking and branching. According to a recent study, banking institutions sold about \$10 billion of proprietary and private-label mutual funds in 1991. Another \$8 billion to \$10 billion in mutual funds and \$9 billion in annuities were sold through third-party broker-dealer marketing companies working with banks. This study found that banks with \$1 billion to \$10 billion in assets were about twice as likely (57 percent to 31 percent) to offer brokerage services to their customers as banks in the \$50 million to \$100 million range. (See Ayotte, Richard A. "Banks Could Be Investment Powerhouses," *American Banker*, Nov. 9, 1992, p.11A. This study was based on a census [not a sample survey] of 6,083 commercial banks and 1,556 savings and loans. The institutions in the census all had more than \$50 million in assets.)

strategy of a bank. A direct connection between interstate banking and price is therefore difficult to make, particularly because comprehensive and consistent information on pricing for all banks is not widely available.³

Although some degree of expanded product offerings is likely for many bank customers, there is no guarantee that customers in any particular market will have access to new products and services in the event that geographic restrictions are eliminated. The availability of new banking services is a function of banks' business strategies—where banks wish to expand and what products they believe they must offer to compete in local markets—and therefore is difficult to predict.

Furthermore, it is likely that at least initially some bank customers will feel that their banking services have not improved as a result of interstate acquisitions of local banks. Bankers and regulators told us that most bank acquisitions are followed by some initial loss of deposits from the merged institution, indicating some customer dissatisfaction with the quality or price of services being offered. In the longer run, however, it seems that banks affiliated with interstate bank holding companies show some recovery in deposits. How management reacts to bank customers' needs will determine how successful a bank will be in retaining or attracting customers. However, as long as markets are competitive, customers will have the option to switch banks if they are dissatisfied with bank services.

Example of Export Financing

Export financing provides an example of the potential benefits associated with interstate banking and branching. As with other benefits, these cannot be quantified and their magnitude depends on management decisions at individual banks.

³As a result of increased competition, the prices of some services, such as fees on some types of accounts, have increased in many banks. This increase represents the result of repricing of various bank services to meet competitive pressures and to better align the revenue and costs of various services. Cross-subsidization of services—taking revenue gained in one service area to lower the cost in another—is harder to maintain in competitive markets where customers have choices about where to buy each particular service.

Exporting has become an important factor in U.S. economic growth⁴ but remain concentrated in a few states and in larger companies.⁵ If the export sector is to continue to grow and be a source of strength to the U.S. economy, a larger number of firms, including many smaller ones, must become involved in exporting. The U.S. financial system must have the capacity and expertise to provide the necessary financing for export activities. Removing federal restrictions on interstate banking and branching could help contribute to both goals by allowing banks with strong export financing interests and capabilities to expand their operations.

Evidence from the Department of Commerce and others indicated that small and medium-sized companies, in particular, have had difficulty obtaining export financing. For small companies, most export financing is internally generated. According to a recent survey, more than 90 percent of the survey respondents used internally generated working capital for export financing; only 7 percent received funding from financial institutions, and 2 percent obtained funding from public sources.⁶

Interstate banking and branching could have a positive impact on export financing, particularly for the exports of smaller companies, primarily by making export financing services more accessible. Although there is not much quantifiable data on export financing, we compiled a list of 21 nationwide banking organizations that are generally regarded as major participants in export financing.⁷ The importance of bank size in the provision of export financing is reflected in the fact that of these 21 bank holding companies, 18 ranked among the 50 largest U.S. bank holding companies as of June 1992.

⁴Exports rose to 10.5 percent of the gross domestic product in 1991, up from 7.5 percent in 1986.

⁵Ten states accounted for \$228.8 billion of the \$421.9 billion in U.S. exports recorded in 1991, or 54.2 percent of the total, with California in the lead (\$50.4 billion), followed by Texas (\$40.1 billion), and Washington (\$27.1 billion). New York (\$23.3 billion) and Michigan (\$20.2 billion) rounded out the top five.

Only 66 companies accounted for 54 percent of all U.S. exports in 1991. The 1991 Grant Thornton Survey of American Manufacturers found that 72 percent of mid-sized firms, defined as those with annual sales of between \$10 million and \$500 million, reported export activity; however, on average foreign transactions represented only 14 percent of total sales. More than half of the mid-sized companies reported that exports constituted less than 10 percent of their total sales.

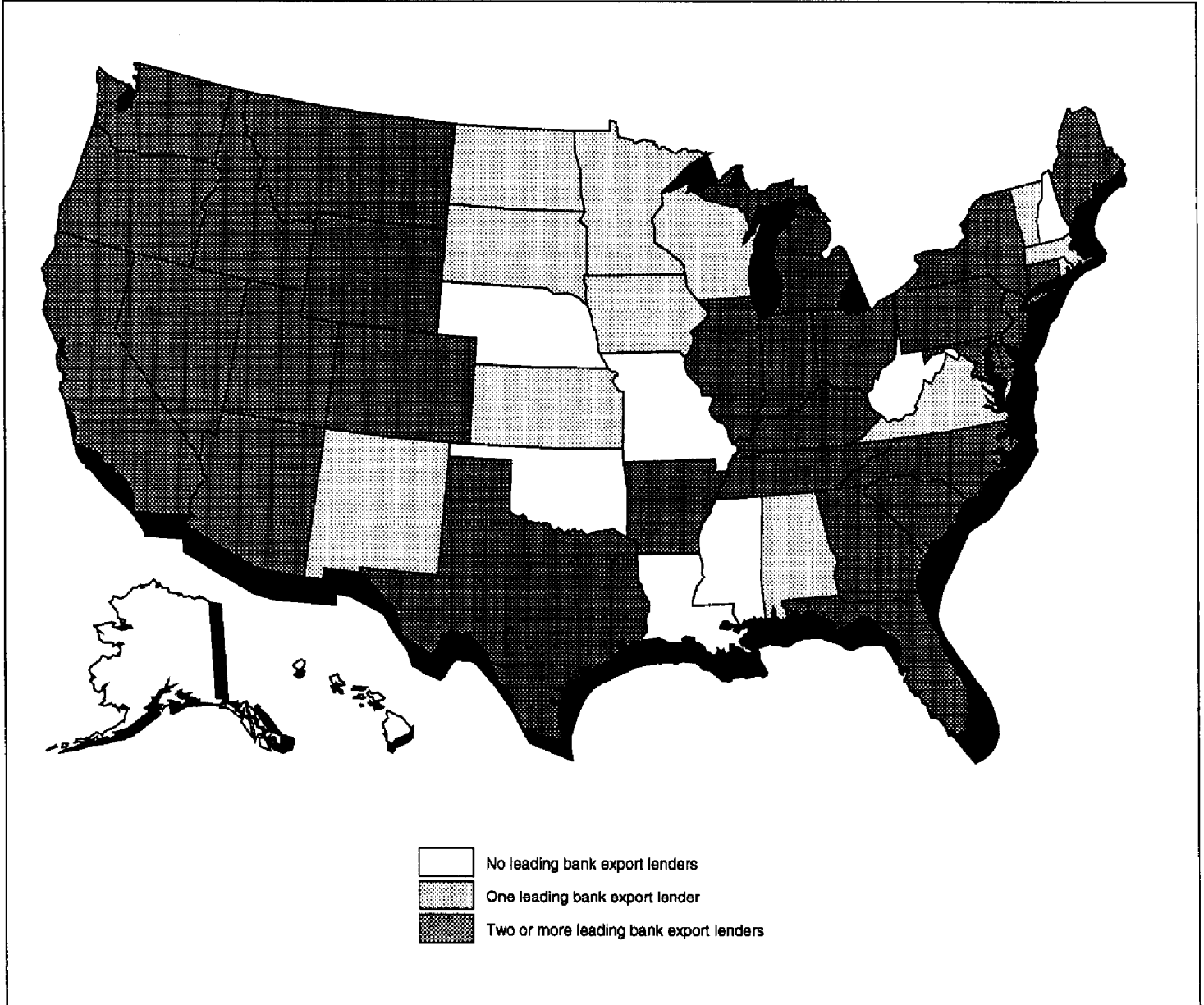
⁶Coopers and Lybrand, *Trendsetter Barometer*, September 1992.

⁷We compiled this list by drawing upon volume activity recorded with Export-Import Bank, published comments, and marketplace perceptions. While we recognize that the methodology employed to derive this list is a judgmental one, we believe it is representative of marketplace activity in export financing.

While the 21 banking companies are headquartered in only 13 states,⁸ interstate expansion by these companies has spread their banking presence to all but 9 states—Alaska, Hawaii, Nebraska, Oklahoma, Missouri, Louisiana, Mississippi, West Virginia, and New Hampshire. Furthermore, firms in 28 states have access to the export financing services of at least 2 of these banking companies, again thanks largely to interstate banking (see fig. 6.1). This interstate expansion may have provided easier access to export financing services for more businesses across the country. Further liberalization of the interstate banking laws would increase the chances that additional businesses would have access to the services of these leading export financing banks and that competition among these banks would increase. However, without a bank's commitment to pursue trade-related business, it is unlikely that any external catalyst will be successful in accomplishing this objective.

⁸The states and the number of bank holding companies headquartered there are New York (5), North Carolina (3), California (2), Pennsylvania (2), Alabama (1), Massachusetts (1), Minnesota (1), Michigan (1), Ohio (1), Texas (1), Illinois (1), Florida (1), and Maryland (1).

Figure 6.1: Geographic Distribution of Leading Bank Export Financing Lenders as of December 31, 1992



Source: Export-Import Bank.

Keeping Markets Competitive Is Essential for Protecting Local Communities and the Economy Against Risks

A concern frequently associated with interstate banking is that banks affiliated with out-of-state bank holding companies will damage local economies by collecting local deposits and lending a significant portion of them outside the communities from which they were collected. The fear is that this phenomenon, often referred to as “deposit siphoning,” will rob local economies of the credit necessary for economic development and growth. Available data can provide no proof to either support or alleviate this concern. However, if banks are safe and sound and banking markets are competitive, we find no reason to conclude that the movement of deposits will necessarily increase as a result of nationwide banking and branching. The ability of banking companies to geographically diversify their deposit taking and lending may also benefit some local communities.

Bank regulators have numerous regulatory tools to control the potential risks associated with industry consolidation and nationwide banking and branching. We have no basis for concluding that these tools are insufficient to serve this purpose. However, it is possible that some unanticipated consequences of nationwide banking and branching may necessitate legislative action to strengthen the tools available to bank regulators.

Efficient Credit Markets Serve National and Local Economies

The efficient flow of credit among regions within the United States creates a tension between the needs of local markets and those of the national market. Some critics of interstate banking are concerned that the needs of residents and local businesses will be subjugated to the credit needs of the larger, corporate clients of the banking companies that will be likely to expand interstate. Although these concerns are important, a well-functioning, efficient credit market—of which banks are a crucial element—is an essential component of a healthy economy. The more efficient the market, the more likely that funds will be directed to the most profitable enterprises, regardless of their location.⁹ It is these enterprises that will contribute most to employment and the growth of the gross domestic product.

⁹In theory, if credit markets are operating efficiently, profitable industries and growing local and regional economies will attract lendable funds away from low-profit, low-growth areas. Differences in credit demand and the returns available to lenders in different industries or regions will influence decisions about where banks invest depositor funds. Thus, in response to changing economic conditions, some regions become net exporters of lendable funds, while others borrow more than would be available from local deposits. New sources of credit should flow into areas in which legitimate credit needs are not being met, and if some banks fail to provide service, others will step in and do so.

The movement of deposits from one location to make loans in another is nothing new. Historically, regional U.S. economic development has depended upon outside sources of capital and credit. Early in its history, for example, the United States depended on credit sources in Europe, primarily England, to finance its growth. As economic expansion moved from east to west, the slower growing eastern states financed growth in the high-growth western states. Yet while there was some measure of credit movement from low-growth to high-growth areas, credit markets remained relatively inefficient. Geographic barriers to credit flows in the 19th century resulted in substantial differences in interest rates among regions, as much as 4 to 7 percentage points according to one study, due in large part to difficulty in obtaining information over long distances.¹⁰ Over time, credit markets gradually became more efficient until eventually they became nationally integrated.

This movement of funds from areas of lesser demand to those of higher demand will continue with or without interstate banking. Even before the onset of interstate banking, banking companies employed a number of mechanisms to respond to differences in loan demand among regions. Smaller banks have historically served as deposit collection agents for large banks, such as the money center banks, that were restricted from establishing branches outside of their headquarters states to collect deposits but made loans to large corporations all around the country.¹¹

The issue, therefore, is not whether the movement of deposits from one community to another will continue but whether changes in federal interstate laws would somehow cause this to happen to an inappropriate degree. If markets function properly, we find nothing inherent in liberalized interstate banking that would adversely affect the balance between local and national interests that exists in the U.S. financial system.

Impact on Local Communities Is Unclear

Market participants and banking experts repeatedly told us that local communities are not at risk from deposit siphoning as long as markets remain competitive. They said that the movement of deposits into or out of local communities is not necessarily a function of size or ownership

¹⁰Davis, Lance E., "Capital Mobility and American Growth," in Fogel and Engerman, *The Reinterpretation of American Economic History*, (New York: Harper and Row, 1971).

¹¹Interstate banking could make credit intermediation more efficient because fewer funds will have to be channeled through smaller community banks to reach the larger banks making the loans. This is not likely to be a significant factor in the volume of deposits that are collected in one location and lent in another, however.

structure and that banks that do not lend locally will have difficulty retaining local depositors. Although it is impossible to anticipate all of the forces that may affect market reactions in the future, we found a good deal of evidence that is consistent with these views.

The diversity of larger bank holding companies' business strategies is illustrated by a study conducted by the House Committee on Banking, Finance, and Urban Affairs in 1992.¹² To the extent available data permitted, this study analyzed the use of funds by the subsidiaries of 15 large bank holding companies with significant interstate operations. The study estimated that 40 percent of the multistate bank holding companies invested a smaller portion of their deposits in-state than the average for all banks in that state; conversely, 49 percent of the bank holding company subsidiaries located outside the bank holding companies' home states had higher than average local investments. Results on the remaining 11 percent were inconclusive.¹³

Other studies have found that banks acquired by out-of-state bank holding companies tend to have higher than average loan to asset ratios. A 1991 nationwide study by the Federal Reserve Bank of Kansas City found that a majority of the banks acquired between 1985 and 1987 increased their loan-to-asset ratios relative to other banks in the same region and that commercial and industrial lending at these banks did not decline relative to their peers.¹⁴ A 1991 study by the Maryland Bank Commissioner compared acquired banks to a group of large competitor banks and found that total loans as a percentage of deposits was higher at the acquired institutions.¹⁵

¹²Analysis of Banking Industry Consolidation Issues, Staff Report to the Committee on Banking, Finance, and Urban Affairs, House of Representatives, 102nd Congress (Washington, D.C.: Mar. 2, 1992)

¹³We have not attempted to independently duplicate the results of the House Banking Committee's study. It should be noted that there are several problems in this and any study associated with reliance on call report data to evaluate bank lending behavior. One is the practice, common among large multistate bank holding companies, of booking many loans at a central location. On the basis of the data available, the Committee study had to include such loans in the home state statistics rather than counting them in the state where the loans were actually made. In addition, loans made by referral to a nonbank subsidiary of a bank holding company would not appear on a bank's consolidated call report. As a result, the Committee analysis excluded local lending by nonbank subsidiaries for such products as mortgages, student loans, and credit cards.

¹⁴Spong, Kenneth, and John Shoenhair, "Performance of Banks Acquired on an Interstate Basis," Federal Reserve Bank of Kansas City, December 1992.

¹⁵Report of the Bank Commissioner to the General Assembly on the Effects of Regional Reciprocal Interstate Banking and Emergency Interstate Acquisitions, State of Maryland, October 1, 1991.

Using a study population similar to that of the Federal Reserve Bank of Kansas City study, we looked at the lending activity of 124 banks that were acquired by out-of-state bank holding companies between 1985 and 1988 and compared their activity with all other banks in the same region and size class.¹⁶ We found that in the years following their acquisition by out-of-state bank holding companies

- 77 percent of the acquired banks increased their total loans outstanding more than the average of the comparison group, and
- 66 percent of the acquired banks increased their commercial and industrial loans outstanding more than the average of the comparison group.

While these studies show increases in loan ratios, data were not available to show where or to whom the loans were made. As a result, the impact on a particular market could not be determined.

A similar situation exists when the lending activities of larger and smaller banks are compared. The benefits associated with interstate banking result from choices among both larger and smaller banking companies. Smaller banks, in general, make loans to small local businesses that are not widely known outside the local market (as we discuss in more detail in the section on small business lending). However, smaller banks also invest a somewhat lower portion of their assets in loans than do larger banks. (See table 6.1.) This lower level of lending by smaller banks generally reflects the need to remain liquid, to diversify risks through the purchase of securities or other nonloan assets, and local credit demand.

Because they are generally more diversified on both the asset and liability sides of the balance sheet, larger banks should also be able to take risks that smaller banks cannot. As a result, the economy as a whole—as well as many businesses located in particular markets—can be well served by the choice between larger and smaller banks that diversification and competition make possible.

¹⁶We studied the portfolio composition of 124 banks that passed from in-state to out-of-state ownership between 1985 and 1988 and remained as bank subsidiaries. The banks were located in 29 states and the District of Columbia. Eighty-one percent of the study population was located in the southeastern or central regions of the country. Ninety-one percent of the institutions studied had less than \$500 million in assets before their acquisition. Portfolio composition for the year before acquisition was compared to the asset portfolio 2 to 3 years after the year of acquisition. Changes in the portfolio of each of the acquired institutions was measured against changes reported for all other banks in the same region and size class.

Table 6.1: Selected Loan-To-Asset Ratios of Banks by Size

Size of bank	Loan-to-asset ratios (In percent)				
	Total loans	Commercial and industrial loans	Mortgage	Other real estate loans	Consumer loans
\$10 billion or more	59%	20%	11%	9%	8%
\$1 billion-\$10 billion	60	14	13	12	15
\$100 million-\$1 billion	57	11	17	15	11
Less than \$100 million	51	9	15	13	9
All banks	58	15	13	12	11

Note: Data are for the period ending December 31, 1992.

Source: Call report data.

The evidence clearly shows that multistate bank holding companies are able to raise local deposits and lend them in the national market. As we discussed earlier, the historic role of banks has been to intermediate funds regardless of the locations of their origin or end use. Such funding has occurred in spite of interstate banking restrictions and will continue whether or not restrictions are lifted. The ability to raise local deposits and lend them in the national market does not mean, however, that local markets will be poorly served by nationwide banking and branching. If markets remain competitive, we would have no basis for concluding that local demands for credit would go unmet if the degree of interstate banking and branching were to increase.

The larger banking companies can provide a stabilizing influence in local communities. The presence of larger, more diversified institutions in local communities could significantly reduce disruptions in banking services associated with bank failures and local economic downturns. We were told by bank regulators in Arizona, for example, that had it not been for the presence of out-of-state banks in Arizona, banking services in the state would have been seriously disrupted when in-state banks and thrifts failed in the 1980s. Larger geographically diversified interstate banking companies may also provide a more stable lending presence than less diversified local banks—such as those that failed in Texas, Arizona, and New Hampshire—because larger banks that operate in more than one market are less susceptible to downturns in local economies.¹⁷

¹⁷A recent Congressional Budget Office study documented that the availability of credit is a function of the health of the banking organizations. Those areas that have experienced the sharpest drop in credit availability in the recent recession are generally the areas that are served by the weakest banks.

We cannot separate the effects of interstate banking from other factors that affect local economies. States with very different banking laws and widely varying levels of out-of-state entry—Texas, Massachusetts, and California—have all experienced or are experiencing severe problems with real estate loans, despite the fact that one state had a tradition of prohibiting in-state branching, one helped launch a regional compact, and the third had a long tradition of statewide branching. Other economic factors—interest rates, changes in oil prices, and defense budget cuts—appear to have played more significant roles. In addition, states experiencing dynamic, growing economies have done so under a variety of interstate banking laws.

It is also important not to lose sight of the growing role of nonbank lenders as they take advantage of profitable lending opportunities. For example, data reported by the Small Business Administration indicated that from 1980 to 1990, business loans outstanding from finance companies more than tripled, from \$90 billion to \$286 billion. If consolidation leaves unmet market demand, the chances are increasing that such demand can be met outside the banking system.

Regulation Must Ensure Competitive Markets

The validity of our conclusion about the effects of liberalized interstate banking depends upon markets remaining competitive and upon small bank viability. At present, we have no basis for concluding that federal safety and soundness, antitrust, and chartering regulations are insufficient to ensure competition and to protect the public against the risks associated with interstate banking. However, we do have concerns in each of these key areas of regulation.

Maintaining Safety and Soundness in Large Banks Is Essential

It cannot be assumed, simply because large banks use a larger percentage of their deposits to make loans, that the economy will necessarily be better served by a relative increase in lending by large banks. As shown in table 6.2, the credit decisions of large banks as a group have resulted in a much higher proportion of net charge-offs of loans as a percentage of net income than has been true for small banks, thus contributing to the poor rates of return of large banks. It can certainly be questioned whether the economy was well served by many of the lending decisions of the large banks that resulted in these losses. These larger proportions of net charge-offs in large banks, once again, illustrate the importance of making sure that banks that are allowed to expand under liberalized interstate

banking laws be adequately capitalized and well managed, as discussed in chapter 5.

Table 6.2: Cumulative Net Income and Net Loan Charge-Offs by Bank Size for 1984-92

Size of bank	Net Income	Net charge-offs
\$10 billion or more	\$40.1	\$86.9
Less than \$10 billion	119.8	98.6

Source: Call report data.

Although geographic diversification makes larger banks less susceptible to local economic downturns, if a large bank with a significant interstate network does fail, it is likely to have a severe impact on local communities throughout its region of expansion. For example, a Federal Reserve official told us that before the Bank of New England failed in 1991, it had become the largest small business lender in New England. Its failure, consequently, had a severe impact on small businesses throughout the region. The prospect that expanded interstate banking and branching could further increase the market shares of regional or even national banking companies raises concerns about the magnitude of economic disruption a single bank failure could cause in local communities across the country.

The potential effect of large bank failures has led to concerns that interstate banking will create more banks that are considered too big to fail or that the proportion of lending undertaken by banking companies that are considered too big to fail will increase. It is generally acknowledged that when a bank becomes troubled, its managers may be tempted to take excessive risks to spark a recovery. Managers of banks considered to be too big to fail will have incentives to take even more excessive risks because they would not be concerned with being disciplined by regulators or the market. Although FDICIA makes it more likely that uninsured depositors will suffer losses if banks fail, exceptions can be made for banks whose failure could destabilize the U.S. economy.¹⁸

¹⁸Proposals to split retail lending using insured deposits from wholesale lending funded by noninsured, wholesale liabilities are intended, in part, to address this problem. Under such proposals, deposit insurance would be limited to "narrow" or "retail" banks that conduct only certain approved categories of lending, such as consumer, small business, or mortgage lending. They might be affiliated with wholesale, noninsured banks in a bank holding company but would be protected from the risks taken by these affiliates through a variety of firewalls and other protections.

The tripwire and internal control provisions in FDICIA are designed to encourage more disciplined lending on the part of all banking companies but are particularly important in disciplining large bank risk-taking because of the impact large bank failures may have on local communities as well as on BIF. It is, consequently, extremely important that regulators forcefully and successfully implement these provisions.

Antitrust Regulation

The public is at risk if consolidation results in the ability of a few institutions to dominate local markets to the extent that they can exert undue influence over price and service. Antitrust and banking laws, enforced by the Department of Justice, the Federal Reserve, and other federal bank regulators (when approving mergers), provide the means to protect against such a result. As we discuss in more detail in chapter 7, their effective use is an important element in making sure that the public will continue to be well served by consolidation in banking.

Entry, Regulation, and the Competitive Position of Community Banks

The U.S. banking system is unique among industrialized nations in its large number of community banks. Although they have declined significantly in number, community banks, as a group, have demonstrated their ability to compete effectively in most markets, as we discussed earlier. For the most part, however, a major change in the conditions affecting community banks has already occurred with the adoption in most states of statewide branching laws. As we noted earlier, the decline in the number of banking companies that has occurred in the last 5 years has been greatest in states that liberalized in-state branching in some way. Whether community banks will remain competitive depends on a number of factors, including developments in the economics of banking, the enforcement of the antitrust laws, and the goals of the owners and managers of both large and small banks. Two areas of particular concern that involve regulation are the chartering of new banks and the regulatory burden under which smaller banks operate.

Regulation will also affect the ability of community banks to compete. It is important that regulations designed to address problems in large banks do not inadvertently make it more difficult for smaller banks to operate. There is reason for concern about the safety and soundness of smaller banks because as we have noted, they have been responsible for a high percentage of the losses in the deposit insurance system. Nonetheless, one of the important goals of the current efforts to assess regulatory burden is

to make sure that the regulatory requirements applicable to smaller banks are appropriate for the risks involved in such institutions.¹⁹

It is also important that new bank charters are not inhibited by excessive regulation of community banks because new entry is an important factor in ensuring competitive markets. It is not valid to assume that simply because there are a large number of banks in the United States that all markets are adequately served by the banks currently in the market and that new charters are not needed.

There is evidence that new banks are commonly chartered in markets that have experienced bank acquisitions. Bankers and regulators provided us with anecdotal evidence of such entry, and a 1989 Federal Reserve Bank of Boston study concluded that new banks in New England were chartered at least "in part in response to a rise in the number and scope of bank mergers and acquisitions."²⁰ Founders of these new banks asserted that they were chartered in response to a decline in the quality of banking services provided to small and local customers. However, the study was not able to conclude whether this was the case or whether bank executives from acquired banks chartered new banks as an alternative career strategy.

This evidence notwithstanding, new bank charters hit a 41-year low in 1992, suggesting a need to at least monitor new charters carefully in the future. We recognize that this decline in new charters may have been the result of numerous influences—the economy, local market conditions, and a high number of failed thrifts (whose purchase provides an alternative vehicle for entry into banking)—and is not necessarily a long-term concern.

While new banks pose special risks—as do all new businesses—the safety and soundness requirements applied to new banks should be no greater than can be justified by the nature of their risk-taking. Continuing oversight in this area is particularly important in a consolidating industry

¹⁹The principle of making distinctions based on asset size is recognized in the law. For example, FDICIA exempts all banks with less than \$150 million in assets—about 80 percent of all banks—from the requirement that a bank's external auditors report on statements prepared by the bank's management regarding the effectiveness of internal controls and compliance with applicable laws and regulations. Furthermore, exercising discretionary authority granted under FDICIA, FDIC issued regulations on June 3, 1993, raising the exemption level for small banks to those with assets of less than \$500 million. 12 C.F.R., 363.

²⁰Dunham, Constance, "New Banks in New England," New England Economic Review, January/February 1989.

because the possibility of new bank charters helps maintain competitive markets.

Another area in which effective regulation could be significant involves protecting smaller banks from unfair pricing by larger banks. However, we found no evidence, either in studies or from interviews, that interstate banking has led to predatory pricing by out-of-state banking companies. Despite assertions by some community bankers and industry groups that unfair competition by large banks is not uncommon, both the bankers and industry groups did not provide us with documentation of such practices. No recent action against any banking company for predatory pricing has been undertaken by the Department of Justice.

Small Business Lending

Problems with small business lending are frequently cited as a potential risk from expanded interstate banking. Such potential problems are an extremely important consideration because a healthy small business sector is a crucial component of the U.S. economy. As has been well documented, the small business sector of the economy has been responsible for most of the net job creation that has occurred in the country in recent years.²¹ Looking forward, there is every reason to expect that small business will continue to be extremely important to the U.S. economy.²²

Very little quantitative data on lending to small businesses currently exist, although the Federal Reserve is planning a national survey on small business financing that will eventually improve data availability.

²¹Between 1976 and 1988, companies with fewer than 500 employees accounted for 50 percent of all private sector employment and 60 percent of net job creation in the United States. From 1988 to 1990, firms with fewer than 500 workers created more than 3 million net new jobs, while larger firms had a net loss of half a million jobs. In addition, between 1976 and 1988, firms with fewer than 20 employees accounted for 19 percent of overall employment and 37 percent of job growth. Between 1988 and 1990, employment at these smallest firms increased by 4 million jobs, while companies with 20 or more employees suffered a net loss of 1.4 million jobs.

The latest figures on small business share of the gross national product, published by the Small Business Administration in 1987, indicated that in 1982 firms with fewer than 500 employees accounted for 39 percent of the gross national product and nearly half of private sector production.

²²It must be recognized that the vitality of the small business sector is a function of many factors. Many of the factors that are related to credit—including economic conditions, access to venture capital, regulatory policy, and lender liability concerns—are not significantly affected by interstate banking restrictions. Other factors affecting small business vitality, such as taxes, government regulation of small businesses, operating costs and product demand, are unrelated to bank credit. Since 1989 no more than 7 percent of respondents to quarterly National Federation of Independent Business surveys ranked credit availability as their most important problem.

Information that does exist showed that smaller, local banks are an important source of financing for many small businesses.²³

In spite of the heavy reliance on smaller banks by small businesses, interstate banking and branching and the increased presence of larger banking companies have the potential for benefiting many small businesses by increasing the volume and accessibility of small business lending, although not every type of business can expect to benefit. We have already pointed out one area that holds promise for such benefits—export financing.

In addition, many larger banks have reportedly indicated that they intend to pursue small business lending as one of their last profitable lending markets—since many of their larger corporate customers now borrow directly from the capital markets. This change in business strategy may be important since smaller banks appear to have been reducing their commercial and industrial lending during the last half of the 1980s and early 1990s.²⁴

²³According to the National Survey of Small Business Finances conducted from 1988 to 1989 for the Federal Reserve and Small Business Administration, most small and mid-sized businesses depend primarily on local commercial banks to meet their credit needs. The survey found that 81 percent of small businesses that obtain credit from any financial source do so from a commercial bank. Ninety-two percent of these firms use local credit sources.

Although data were not available on the percentage of commercial and industrial lending to small businesses, most of the banking officials and others with knowledge of the market to whom we spoke agreed that small banks make a large portion of the loans to small businesses. Surveys that the Federal Reserve conducts periodically on the terms of commercial lending by banks of different sizes confirm a pattern that most of the smallest loans made by banks are made by the smaller banks. In surveys conducted in 1991, banks not among the 54 most active commercial lenders, whose commercial and industrial loans generally totaled less than \$1.6 billion, accounted for about one-third of all such loans outstanding and about two-thirds of all such outstanding loans of less than \$1 million each. (See special table 4.23, "Terms of Lending at Commercial Banks," published periodically in the Federal Reserve Bulletin.)

²⁴Statistics concerning small business lending by banks are difficult to interpret, especially for small banks, because small business loans may be classified by banks as real estate, home equity, or even credit card loans in addition to the traditional commercial and industrial loan category usually associated with business lending. Nonetheless, commercial and industrial loans outstanding for banks in both the less than \$100 million and \$100 million to \$1 billion asset categories have declined since the mid-1980s. For banks with less than \$100 million in assets, commercial and industrial lending declined from \$48.5 billion in 1986 to \$32.7 billion in 1991—a 33-percent drop. For banks with \$100 million to \$1 billion in assets, commercial and industrial lending declined from \$92.6 billion in 1986 to \$79.8 billion in 1991—a 14-percent drop.

Effective Regulation Can Minimize the Adverse Effects That Consolidation Is Likely to Have on Some Small Businesses

Although interstate expansion and consolidation in the banking industry may lead to more lending to the small business sector in general, small businesses whose size, condition, or credit requirements do not fit into a standardized approach may be adversely affected by the methods used by larger banks in assessing credit risk. Such businesses would tend to include those with unique operations or uncertain creditworthiness. The credit needs of these businesses are likely to involve more intimate knowledge of their operations than may be cost-effective for many larger banks to obtain.

Some larger banks have already become important sources of small business credit. For example, one large regional bank has a portfolio of \$715 million of small business loans. The average size of this bank's outstanding small business loans is about \$81,250, and more than half the loans are for less than \$50,000. Nevertheless, it seems reasonable to conclude that the focus of many larger banks likely will be on the more standardized types of credit.²⁵

The number of small businesses most likely to experience difficulties in dealing with larger banks is hard to estimate. But it is possible that a substantial share of the small businesses in the country will be affected. According to statistics compiled by the U.S. Bureau of the Census in 1989, approximately 6.1 million business establishments had payrolls. Of this number, 5.3 million—more than 85 percent—employed fewer than 20 people. Most of these smaller establishments (which employ 24 million or, about one-quarter of all private sector employees) would have annual sales of less than \$1 million. In addition, most of these establishments probably do not have audited financial statements and, given the turnover in businesses, may not have been in business very long.

In our analysis of the banking markets in California, Arizona, and Washington, we conducted 11 focus group discussions on the subject of credit availability for small businesses. Many participants in the focus groups believed that many small businesses were having a harder time obtaining credit than they did in the past. Although it was recognized that economic factors played a part and that credit standards have been tightened because of the numerous bank failures, many also felt that the

²⁵To ensure consistency in underwriting standards, many large banks have adopted a standard set of criteria for considering small business credit applications. Such criteria might include years in operation, amount and term of current debt, history of earnings and debt service performance, financial condition and cash flow projections, and value of collateral. Lenders using such "credit scoring" systems may have less flexibility to consider local economic conditions or special circumstances in evaluating borrower creditworthiness.

centralized lending procedures followed by some larger banks contributed to small business credit availability problems.

Smaller banks are a vital part of today's credit markets. Future industry consolidation may increase credit concerns for the smallest businesses. However, these risks are not unique to the consolidation that would result specifically from the liberalization of interstate banking laws.

Any adverse impact of consolidation on certain segments of the small business sector can be minimized through actions designed to keep markets competitive. These actions include carefully enforcing safety and soundness and antitrust regulations, ensuring that the chartering of new banks is carried out in a way that will provide fair and open competition in local markets, and ensuring that banking companies are not subject to excessive regulation.

Even when regulation is successful in keeping markets open and competitive, some credit problems may be encountered by some businesses. New entry will not immediately resolve all potential small business lending problems in the wake of bank acquisitions—because it takes up to 2 years to organize and charter a new bank and most new banks start small, limiting their initial ability to add significantly to local credit availability.

Interstate Banking and the Community Reinvestment Act

Some critics of expanded interstate banking have raised concerns that low-income communities, in particular, would be disadvantaged by any additional consolidation that might accompany changes in interstate banking and branching laws. Currently, the principal regulatory tool available to deal with these concerns is enforcement of the Community Reinvestment Act of 1977 (CRA).

CRA Is a Factor in Merger Applications

Under CRA, federal bank regulators rate the performance of financial institutions in helping meet community credit needs, including those of low- and moderate-income neighborhoods. Bank CRA performance is evaluated in the following five categories:

- ascertainment of community credit needs,
- marketing and types of credit offered and extended,
- geographic distribution and record of opening and closing offices;
- discrimination and other illegal credit practices, and

- community development.

CRA requires federal regulatory agencies to consider a bank's CRA performance in acting on any "application for a deposit facility," including mergers and acquisitions of financial institutions.

There is no question that the problems CRA seeks to address are important issues for our economy and society. Low-income communities, particularly inner city areas, have severe problems concerning access to banking services. The price of basic banking services has risen. Bank industry consolidation, particularly for large in-market mergers, has tended to reduce the number of bank offices in cities. Large areas in such cities as Los Angeles and New York City lack a single full-service branch bank. According to a study by the City of New York, other areas have population-to-bank ratios four and five times higher than the national average. The growth of the check cashing industry and pervasive anecdotal evidence about the lack of credit in low-income urban areas suggests an absence of banking services in markets.

Since the passage of CRA in 1977, federal banking agencies have denied only a small number of mergers and other bank applications on CRA grounds. This does not, however, necessarily indicate the impact CRA may have had on the provision of bank services. Some institutions may have withdrawn merger applications to avoid denials on CRA grounds. Furthermore, institutions interested in making acquisitions have strong incentives to conform to CRA requirements since the enforcement of CRA centers around requests for approvals of applications. As a result, they may have focused more effort on CRA than they might have otherwise.

Furthermore, because of CRA's importance in the merger approval process, it appears to have played a role in reducing some of the adverse consequences of bank consolidation in communities where market forces have not favored the development of vigorous competition among financial services providers. For example, it is likely that some of the branches serving poor, inner-city neighborhoods remain today at least partially as a result of pressure from community groups who have used the merger application approval process to seek CRA commitments from acquiring institutions.²⁶ Were it not for the presence of large bank branches in these neighborhoods, banking services would be all but nonexistent. Smaller banks are generally not subject to such public

²⁶These large banks generally started serving the larger urban areas when they were still relatively prosperous.

pressure because they are involved in fewer applications for mergers and branch openings and closings.

CRA Does Not Address All Banking Problems of Underserved Neighborhoods

Conflicting concerns about CRA include views that it is burdensome but still insufficient to address community lending problems. Critics of the CRA process assert that CRA exams do not necessarily reflect a bank's actual lending practices but rather the adequacy of its documentation of CRA activities. CRA standards contain little specificity about what services should be provided by banks. Consequently, criteria for determining CRA ratings are fairly subjective.

There are also public policy concerns that CRA is not able to address. For example, banks cannot be forced to enter markets that are underserved. At most, CRA can provide incentives for banks to remain in markets. Furthermore, public concerns about CRA are most likely to focus on larger banking companies whose mergers are most likely to attract community attention. Yet small banks may be equally suited to address the needs of borrowers who do not conform to broad lending categories.

Because certain communities remain underserved, it appears appropriate to consider other ways to supplement CRA or make it more effective in order to improve the banking services in these areas. However, an evaluation of the process or potential improvements or additions to CRA was beyond the scope of this report. We are currently conducting a separate review on the efficiency and effectiveness of CRA.

We did, however, consider the more focused question of how banking services to local communities or CRA might be affected by nationwide banking and branching. On the broader issue of services to local communities we were unable to reach a conclusion. We found no evidence from our many interviews with community representatives that nationwide banking would have a significant impact—either positive or negative.

Large bank mergers, however, often focus extra attention on CRA. As a result, local community groups are often able to obtain CRA commitments from the banking companies involved in the merger that they might not otherwise obtain. To the extent that nationwide banking would encourage such mergers, local communities might benefit on a case-by-case basis.

Interstate branching could have a potentially significant impact on the way CRA is administered. Under current CRA requirements, banks, whether they operate in 1 local market and have no branches or in 50 markets with 200 branches, receive a single CRA rating. For example, Bank of America gets a single CRA rating for the entire state of California. If interstate branching were allowed without changes to CRA reporting requirements, banking companies would still only be examined for CRA compliance at the bank level. A large degree of specificity in the examination process would consequently be sacrificed. For example, if NationsBank consolidated its 11 banks into 1 bank, it would receive a single CRA rating for its operations in 10 states and the District of Columbia, whereas it now receives a rating for each of its 11 bank subsidiaries.

Conclusions

Many banking services that are not directly available through local banks are available through correspondent banking relationships or through direct solicitations from large, out-of-market banking companies. Nevertheless, the elimination of geographic restrictions on banking and branching has the potential to benefit the economy in a number of ways as long as competition is maintained as we discuss further in chapter 7. Local communities may benefit from the more stable presence of more diversified interstate banking companies. Furthermore, the elimination of branching restrictions and the increase in competition fostered by interstate banking and branching may enhance customer convenience, increase the availability and accessibility of banking services, and reduce the cost of those services. Nevertheless, not all bank customers are likely to feel that the acquisition of local banks by out-of-state banking companies is in their best interest. If markets are competitive, however, dissatisfied bank customers will have the option of turning to other banks or financial services providers to serve their needs.

The benefits to bank customers and the economy associated with interstate banking and branching are not automatic, however. The realization of benefits depends, to a great extent, on bank management. The impact of interstate banking and branching will, consequently, vary by banking company and by community.

Concerns have been raised about the adverse impact interstate banking and branching could have on local communities, the small business sector, and on economically disadvantaged borrowers. These concerns are by no means unique to liberalizing federal interstate banking and branching laws. Nevertheless, to the extent that interstate banking may accelerate

the trend toward consolidation, it is important that the concerns be addressed.

Although we have found no evidence that nationwide banking and branching will result in a greater degree of deposit siphoning, larger banks—particularly those that operate interstate—could have a significantly disruptive effect on numerous local communities if they fail. Furthermore, while some small businesses may benefit from large bank lending, others, who do not conform to standardized lending processes, may find it more difficult to obtain loans. Whether small businesses' borrowing needs will be met in the wake of mergers will depend largely on bank management, nonbank credit sources, and new bank entry into local markets whose small business needs are not being supplied adequately. There is some evidence that new bank or financial services entry will take place in markets that have experienced bank mergers.

We have no reason to believe that the tools regulators have are insufficient to control the potential risks associated with nationwide banking and branching. Strong enforcement of the tripwire and internal control provisions of FDICIA will reduce the likelihood of disruptive bank failures. Antitrust and other regulatory actions to ensure that markets remain competitive and that excessive regulation not discourage bank charters or the operation of small banking companies are critical to ensuring that the market will fill gaps in the provision of banking services. However, additional regulatory authority may prove necessary if unanticipated consequences of consolidation and nationwide banking and branching develop.

CRA appears to have served as an incentive to spur larger banking companies that want to expand into increasing their commitment to inner cities and other underserved areas. But CRA alone is not sufficient to address all of the banking problems in these areas. Maintaining geographic restrictions to bank ownership will certainly not solve the banking problems of these areas. Interstate branching could, however, have a significant impact on CRA by reducing the specificity of CRA examinations unless changes are made to the CRA reporting requirements to make them more regionally specific.

Given the complexity of these issues, regulators need to adapt their judgments to changing circumstances in the banking industry. These concerns are relevant even if federal laws on interstate banking and

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Impact on the Economy

branching are not liberalized given the structural changes currently occurring in the banking industry.

Antitrust Considerations

Chapter Summary

Topic	Principal Findings
<p>This chapter discusses the impact banking industry consolidation could have on market power and the role antitrust enforcement plays in ensuring that markets do not become overly concentrated or anticompetitive.</p>	<p>Antitrust enforcement in future bank mergers is critical to ensure competitive markets, whether or not geographic restrictions are lifted. Although antitrust enforcement appears to be able to prevent anticompetitive mergers, the following factors give rise to some uncertainty about the impact nationwide banking and branching could have on market power:</p> <ul style="list-style-type: none"> • The relevant market area for antitrust enforcement in banking has generally been local. • It has become harder to define product markets relevant for antitrust purposes. <ul style="list-style-type: none"> • At the local market level, at least 130 of the nation's 318 urban markets are already dominated by 3 or 4 banks. • It is impossible to predict how nationwide banking and branching may affect the structure of and competition within the industry. <p>Because of these factors and the amount of judgment involved in antitrust analysis, oversight of antitrust enforcement is important.</p>

Concerns about market power—the ability of one or more firms to maintain prices above competitive levels—arise whenever any industry experiences significant consolidation. Antitrust statutes are designed to ensure that such power is not achieved by any one company or group of companies.

The consolidation that has already occurred in the banking industry has raised antitrust concerns in certain markets. Consequently, whether or not geographic restrictions are lifted, careful enforcement of antitrust statutes will continue to be important when mergers are approved. Rigorous oversight of antitrust enforcement will also be necessary to ensure that banking markets remain competitive, particularly because antitrust enforcement requires a great degree of legal and economic judgment and because the Federal Reserve and the Department of Justice do not always agree in several judgment areas.

Nature of the Concerns

The nature of potential concerns about concentration and market power resulting from interstate banking and branching varies depending on the

markets being considered—local, regional, or national—and the time frames under discussion.

National and Regional Markets

As we discussed in chapter 1, the Bank Holding Company Act restrictions on interstate banking were imposed partly as a result of concerns about concentration of economic power at a national or regional level in a small number of banking institutions. The potential increase in concentration at the national and regional levels that would result from the interstate mergers of some of the largest banks in the United States remains a concern.

As we noted earlier, the nature of competition in the financial services industry has changed considerably since the passage of the Bank Holding Company Act in 1956. Banking companies face more competition from nonbank financial services providers than they did then, making concerns about national oligopolies in financial services much less credible. Nevertheless, bank management strategy might encourage a string of acquisitions that over time, could create a few large banking institutions wielding considerable market power.

It is also possible that the merger of large banks will affect competition in specific markets in which large banking and other financial services organizations compete on a national or regional level, such as securities clearing or American depositary receipts.¹ However, it is often difficult to describe such markets as purely national in scope, because foreign financial service providers often compete in these markets.

Local Markets

To date, antitrust actions in banking have focused more at the local market level than at the national or regional level. Removing geographic restrictions of any kind generally provides opportunities for reducing concentration or market power in local markets. Lifting restrictions on interstate banking would increase the number of firms legally able to enter most banking markets, and markets considered likely to be profitable will attract new banks. Even if banks do not actually enter such markets, the increased possibility of new entry may limit the market power of existing banks because banks may not raise prices if they know others will enter to contest their market. In addition, in the short to medium term, interstate banking may reduce pressures leading to increased concentration because

¹American depositary receipts are securities issued by U.S. banks against the shares of a foreign-based corporation held by a U.S. bank entitling the shareholder to all dividends and capital gains.

it will give growth-oriented banking companies the opportunity to expand outside of their current markets—either through branching or acquisitions—rather than force them to consolidate within those markets.

Nevertheless, interstate mergers involving large banking companies with significant geographically overlapping operations can increase local market concentration—a point of some significance since many local markets are already relatively concentrated. In 1991, for example, the three largest banking companies in over two-fifths of the U.S. urban markets held at least 70 percent of the total commercial bank deposits.² While geographic overlaps are currently few, if banking companies expand nationwide and extend their networks, the likelihood of future mergers among larger institutions with overlapping local markets increases.

Most Mergers Have Not Raised Antitrust Considerations

Federal bank regulators, some state bank regulators, the Department of Justice, and state attorneys general have responsibility for enforcing the antitrust laws relevant to the banking industry.³ The Federal Reserve and Department of Justice have been most involved in assessing the competitive effects of interstate mergers. The enforcement of the antitrust laws—which are very broad—is facilitated by guidelines issued by the Department of Justice. The guidelines provide, among other things, a methodology to screen all proposed mergers for potential adverse competitive effects. This screen assists regulators in determining which mergers have the potential to enhance or create market power and should be investigated further. Nonetheless, implementing the screen requires a significant amount of judgment by the regulators. The vast majority of proposed banking company mergers has not exceeded the screen.

²These statistics tend to exaggerate concentration in banking markets because they do not take into account the competitive effects of thrifts or other nonbank competitors.

³Throughout this report, we refer to antitrust laws as any laws or sections of laws relevant to the banking industry whose purpose is to prevent anticompetitive behavior. These include the laws enforced by the Department of Justice, including the Sherman and Clayton antitrust acts, as well as certain sections of banking law found in the Bank Merger Act, the Bank Holding Company Act, and the Change in Bank Control Act.

Legal Basis for Antitrust Assessment

The purpose of antitrust laws is to prevent anticompetitive behavior and preserve and promote competition. The Sherman Act⁴ and the Clayton Act⁵ are the linchpins of federal antitrust enforcement. In general, they—and several state antitrust statutes that mirror their provisions—prohibit mergers that would result in or tend to create a monopoly or may substantially lessen competition. The Department of Justice is charged by the acts to enforce the antitrust statutes in all industries, including banking.

Until the Bank Merger Act was passed in 1960, it was not clear whether bank regulators had the authority to deny bank mergers that were anticompetitive. To remedy this uncertainty, the act mandated that bank regulators with responsibility over the surviving bank consider the competitive effects of bank mergers⁶ but did not specify the standards bank regulators should apply in assessing these competitive effects.⁷ There was also considerable confusion about whether the Sherman and Clayton antitrust acts applied to the banking industry. In 1963, the Supreme Court clarified this matter in the *Philadelphia National Bank* case,⁸ holding that these laws, and particularly section 7 of the Clayton Act, which prohibits mergers or acquisitions that tend to create a monopoly or that may substantially lessen competition, applied to the banking industry. The

⁴Section 1 of the Sherman Act (15 U.S.C. sections 1 through 7) makes illegal any contract, combination, or conspiracy that results in a “restraint of trade.” Courts have interpreted this to cover a variety of horizontal and vertical trade restraining agreements. Horizontal restraints are agreements among competitors at the same level of the production or distribution process (e.g., among competing manufacturers or distributors). Vertical restraints are arrangements between persons or firms operating at different levels of the manufacturing or distribution chain (e.g., between a manufacturer and a wholesaler) that restrict the conditions under which the firms may purchase, sell, or resell. Section 2 of the Sherman Act also prohibits monopolization as well as attempts, combinations, or conspiracies to monopolize.

⁵The Clayton Act, as amended, (15 U.S.C. sections 12 through 27) supplements the Sherman Act by proscribing certain types of market behavior that may restrain trade. Section 7 prohibits certain mergers or acquisitions of stocks or assets of firms engaged in interstate or foreign commerce. In general, mergers and acquisitions covered by section 7 are unlawful if they would tend to create a monopoly or may substantially lessen competition.

The Hart-Scott-Rodino Antitrust Improvements Act of 1976, which added section 7A to the Clayton Act (15 U.S.C. section 18a), provides several mechanisms to assist the Department of Justice in investigating whether proposed mergers and acquisitions would be anticompetitive.

⁶The Federal Reserve has responsibility for state member banks, FDIC has responsibility for state nonmember banks that have federal deposit insurance, and OCC has responsibility for national banks.

⁷The Bank Holding Company Act of 1956 required an assessment of the competitive effects of bank acquisitions by a bank holding company—in contrast to bank mergers. However, before 1960, there were very few significant holding company acquisitions, and the competitive requirement of the Bank Holding Company Act was rarely applied.

⁸*United States v. Philadelphia National Bank*, 374 U.S. 321 (1963).

court also held that mergers approved by bank regulators were not immunized from further antitrust challenges.

Following the Philadelphia case, Congress further strengthened bank merger enforcement efforts by amending both the Bank Merger Act and the Bank Holding Company Act in 1966 and by passing the Change in Bank Control Act in 1978. These amendments and the Change in Bank Control Act introduced the language of the Sherman and Clayton antitrust acts into the banking laws.⁹ As a result, federal bank regulators and the Department of Justice generally enforce similar antitrust statutes when addressing the competitive concerns arising from bank mergers.

State attorneys general and some state bank regulators also have the authority to enforce state antitrust laws relevant to the banking industry. State attorneys general may also bring actions on behalf of state residents for federal antitrust offenses. We surveyed all state attorneys general and state bank regulators to try to determine the extent of their involvement in assessing the competitive effects of bank mergers. Of the 43 state attorneys general who responded to our survey, 15 indicated that they assess at least selective bank mergers in their states for competitive effects and several others indicated that they would assess bank mergers if they thought there was a particular need to do so. Of the 42 state bank regulators who responded to our survey, 21 indicated that they assess at least selective bank mergers in their states for competitive effects.

Although antitrust laws are enforced by numerous state and federal regulators, we focused our analysis on the Federal Reserve and the Department of Justice because they have been involved in all recent interstate mergers. The Federal Reserve assesses the competitive effects of all bank holding company mergers and, consequently, all interstate mergers because banking companies may only acquire other banking companies across state lines through the bank holding company. The Department of Justice is not required to act on every bank holding company merger, as must the Federal Reserve, but Justice staff said they review virtually all mergers and acquisitions in the banking industry and they have the responsibility to challenge any merger that significantly reduces competition.

⁹The acts also require the bank regulators to consider whether certain public interest factors outweigh any anticompetitive effects of mergers.

Process for Assessing Banking Company Mergers

Merger applications are submitted to the Federal Reserve Bank with geographic jurisdiction, which then sends a copy to the Department of Justice and other relevant bank regulators. The Federal Reserve has 60 days to approve or deny an application from the time it is formally accepted,¹⁰ and the Justice Department has 30 days after the Federal Reserve approves an application to seek a preliminary injunction enjoining the consummation of the merger. Federal Reserve and Department of Justice officials said they often work informally with merger applicants to work out any competitive concerns that may arise from the merger.

During the time the Federal Reserve and Justice are preliminarily reviewing a merger application, an applicant may file amendments to its application with the Federal Reserve. In addition, Justice staff will inform the merger applicant of any competitive concerns and attempt to work with the parties to eliminate the problems rather than resort to litigation. Most merger applications are approved by the district Federal Reserve Banks. However, under current Federal Reserve policy, the Board of Governors of the Federal Reserve must approve merger applications that raise antitrust concerns.

Department of Justice Guidelines Provide the Basis for Merger Analysis

The language of the antitrust statutes is sufficiently broad to provide the authority to address the potential competitive concerns raised by nationwide banking and branching we discussed earlier. How these concerns are actually addressed, however, depends on the enforcement of the statutes. In order to facilitate antitrust enforcement, the Department of Justice has issued Merger Guidelines that provide the basis for the merger analysis of the Justice Department and the Federal Reserve and implement the language of section 7 of the Clayton Act.¹¹

The Merger Guidelines describe the analytical framework and specific standards used to assess the effect of proposed mergers on market power. The guidelines describe a methodology for measuring the level of market concentration that will result from a merger. They also describe other factors regulators should consider that could affect the level of

¹⁰Regulation Y gives the Federal Reserve 60 calendar days after the Federal Reserve Bank accepts an application to act on the application, unless the Federal Reserve notifies the applicant that the 60-day period is being extended for a specified period and states the reasons for the extension. Federal Reserve staff told us that some complicated cases take significantly longer than 60 days to process.

¹¹The Department of Justice, which issued these guidelines in 1968 and revised them in 1982, 1984, and 1992, follows them when assessing mergers in all industries. Although the focus of the Merger Guidelines has changed over the years, each version is alike in its basic elements. The 1992 guidelines were issued jointly by the Department of Justice and the Federal Trade Commission.

competition in a market after a merger. Although the guidelines describe a general methodology to assess mergers and improve the predictability of the outcome of the merger review process, determining whether a merger will create or enhance market power requires regulators to exercise a great deal of judgment. It is not possible to mechanically assess the competitive impact of bank mergers.

Because concentrated markets are generally considered to be a necessary condition for market power, an important focus of the Merger Guidelines is to limit merger-induced increases in market concentration.¹² To accomplish this goal, the Merger Guidelines establish post-merger concentration standards—based on the Herfindahl-Hirschman Index (HHI)—which the Federal Reserve and the Justice Department use to help them evaluate the potential impact of mergers on competition.

HHI is calculated by adding the squared market shares—generally based on deposits—of each bank and thrift in a market.¹³ This calculation accounts for both the number of banks and thrifts in a market and their relative sizes, since squaring the market shares emphasizes the larger banking companies. The maximum value of HHI is 10,000, or 100 percent squared, for a market with only 1 bank or thrift. The minimum value of HHI approaches zero for a market with a very large number of similarly sized banks and thrifts.

HHI Is Used to Screen Mergers

Federal Reserve and Justice Department officials use HHI as a screening mechanism to eliminate from further review mergers that do not have the potential to adversely affect competition. If mergers exceed the screen—a post-merger market HHI that is above 1800 with an HHI increase of more than 200—then the Federal Reserve and the Justice Department will investigate them further for potential anticompetitive effects. An HHI of

¹²The basic model of industrial organization economics is that the market structure—or concentration—of an industry affects the conduct of the firms in the market, which influences the firms' performance. Empirical tests of this model have generally indicated that higher market concentration is associated with higher firm profits. The traditional explanation of this relationship is that higher market concentration causes higher profits because in more concentrated markets, firms have greater market power so they can raise prices either unilaterally or through collusion. Some economists have argued that the observed relationship between concentration and profits is not a causal one. They argue that more efficient firms tend to grow larger than other firms so that market concentration in markets with large efficient firms will be high. The merger analysis of the Federal Reserve and Justice Department has relied on the former interpretation—that greater market concentration causes higher profits.

¹³The Justice Department has considered whether other nonbank competitors, such as finance companies, should be included in its HHI calculations. Also, the Federal Reserve and the Justice Department may weight the deposits of thrifts when calculating HHI to account for the thrifts' limited activity in the market.

1800 corresponds to a market in which the 3 or 4 largest banking companies account for about 70 percent of the market.¹⁴ The banking industry HHI screening standard is somewhat more lenient than the lower HHI standard the Justice Department uses for all other industries to approximate the possible competitive influence of nonbanking companies located in the market.¹⁵

Even this somewhat mechanical screening process requires a certain level of judgment, and the more judgment involved, the less predictable the outcome of the antitrust review process. For example, to calculate HHI levels, judgments must be reached about the geographic markets, the market participants, and the weight to give market participants.

For the purposes of screening bank mergers, the Federal Reserve uses the district Federal Reserve Banks' geographic market definitions, and the Department of Justice generally uses the same definitions. These markets are generally defined as standard metropolitan areas, Rand McNally areas, or rural counties. Yet the Federal Reserve may make adjustments to these areas on the basis of judgments about commuting and shopping patterns, banking relationships, and other related information.

The HHI screening process also requires the Department of Justice and the Federal Reserve to make a judgment about the likely market participants and the amount of weight to place on the participants.¹⁶ Both Justice and the Federal Reserve include all banks in a market and give them full weight when calculating their market shares for the HHI screen. In addition, the Federal Reserve generally includes all thrifts in the market

¹⁴If a market includes 2 banks each with a 25-percent share of deposits and 2 banks each with a 15-percent share, HHI accounted for by these 4 banks is 1700. A variety of smaller banks would affect the index relatively little. For example, if the remaining 20-percent market share were divided equally among 4 banks, HHI for the 8-bank market would be 1800. If a market had one bank with a 30-percent market share, two with 20 percent, and several smaller banks, the results would be about the same.

¹⁵The Department of Justice Merger Guidelines criteria to identify mergers that raise significant competitive concerns are a post-merger HHI above 1800 and an increase in the HHI of more than 50. Justice adopted a screening standard of a 200-point increase in banking because it believed that a deposit-based HHI did not adequately recognize that nonbank financial institutions—such as credit unions, finance companies, money market funds, and brokerage firms—may provide competition for banking products but that their competitive influence is difficult to measure. When Justice conducts full-scale investigations of mergers, it generally utilizes an 1800/50 HHI standard in conjunction with the more precise HHI data developed through investigations.

¹⁶The weight given to market participants is generally calculated by taking some percentage of the participants' deposits. HHI is then calculated based on weighted market shares.

weighted at 50 percent, and the Justice Department generally includes thrifts weighted at 20 percent.¹⁷

The HHI screen is a critical element in antitrust enforcement because setting the HHI limits too high would, of course, allow anticompetitive mergers to be approved, while setting them too low would require the Department of Justice and the Federal Reserve to investigate many more mergers than necessary to ensure adequate competition. No studies to date provide empirical evidence that delineates the exact point at which markets become so concentrated that market power can be established, although economic studies have generally established a positive relationship between market concentration and prices. We have no independent basis for evaluating the 1800/200 HHI screen, although analysts we talked with agreed that the HHI levels set in the guidelines represent a reasonable approximation of critical concentration levels, and Justice staff said that they have not received complaints about the current HHI limits.

Examining markets for postmerger concentration levels that exceed the HHI standard permits the Federal Reserve and Justice Department to screen a large number of mergers quickly and at a relatively low cost. This examination is particularly important given the high number of mergers in the banking industry. In 1991, Justice reported that it reviewed over 1,500 mergers. This included virtually every proposed bank, thrift, or bank holding company merger, consolidation, or acquisition, including Resolution Trust Corporation or FDIC transactions involving failed or troubled institutions. The Federal Reserve reported that it reviewed 336 state member bank and bank holding company mergers in 1991.

The vast majority of mergers do not result in local market concentration levels that exceed the HHI screen. For example, in 1991 Justice said about 40 to 50 of the more than 1,500 mergers it reviewed exceeded the HHI screen. However, some of the mergers that have exceeded the screen have been large and well-publicized mergers, such as the BankAmerica-Security Pacific and Fleet/Norstar-Bank of New England mergers.

¹⁷The Justice Department may also calculate the HHI screen with thrifts given full weight. The result of this screen will be more binding than the screen including thrifts weighted at 20 percent if one of the parties to the merger is a thrift, or if thrifts have leading positions in the market.

Most Concerns Resulting From Mergers Are Resolved Through Divestitures

If the Department of Justice or the Federal Reserve determines that a proposed merger will exceed the HHI guidelines in any geographic market, they will investigate the merger further to determine if it is likely to be anticompetitive. They also may investigate further any merger of banking companies that, in their judgment, could have an adverse effect on competition, even though the screen was not exceeded. They might undertake such an investigation if, for example, they had some reason to believe that data used for the screen did not accurately reflect the competitive conditions in a particular market.

In this second step of a merger investigation, Justice and Federal Reserve officials may consider a number of factors, including a more detailed examination of the market and its participants, the potential for new entry into a market, economic and other market characteristics, and the health of the acquired bank. This additional investigation addresses some of the uncertainties associated with the HHI screen. The investigation might reveal that the merger is unlikely to create or enhance market power even though the concentration in the market exceeded the HHI screen. On the other hand, the investigation might reveal some concerns about market power. In the latter case, most concerns have been resolved through divestitures of certain banking assets and deposits.

Refinement of Market Definition and Market Participants

If a merger fails the initial HHI screening test, both the Department of Justice and the Federal Reserve may refine their definitions of the product and geographic markets and the market participants initially used to calculate HHI. With the more precise definitions of markets and market participants, they will again calculate concentration levels and compare them to the guidelines, and if the concentration levels still exceed the guidelines, continue their analyses.

Product Market

The Justice Department's Merger Guidelines generally define a product market as the smallest group of products a hypothetical monopolist could profitably sell if it imposed a small but significant and nontransitory increase in price. To define this market, Justice staff determine if there are substitutes for the particular products bought by the customers who Justice believes might be most adversely affected by a merger. For example, if the price of a commercial loan were increased by 5 percent, Justice would consider whether a small business customer would shift away from that loan to another type of loan.¹⁸ If not, Justice staff would

¹⁸To obtain the information needed to do this analysis, Department of Justice staff might interview customers and banks and other financial services suppliers in a market to determine the choices and relative prices of services available to customers.

define commercial loans as the relevant product market. In recent bank merger investigations, Justice Department staff have defined relevant product markets to include transaction accounts and loans to small businesses and to middle market businesses.¹⁹ The product market definition depends, among other things, on the banks involved in the merger and the characteristics of the local market.

The Federal Reserve generally does not refine its analysis in this area but continues to define the product market as the cluster of banking products and services.

Geographic Market

When examining products or services for locally limited customers, the Justice Department staff generally start with the district Federal Reserve Banks' definitions of geographic banking markets and then adjust them if necessary. For other relevant product markets, however, Justice may adopt regional or nationwide geographic markets based on the degree to which more distant suppliers are acceptable alternatives for consumers. Because the Federal Reserve generally does not analyze product markets other than the traditional cluster of banking services, it generally does not redefine geographic markets in this part of the investigation, although it may reexamine whether markets have changed since they were last defined.

Market Participants

Once Justice staff have identified the relevant markets, they reevaluate the firms that are considered to be market participants. This analysis is most often focused on whether to include thrifts as participants. Justice staff said they examine each thrift individually and include in the market only thrifts that provide the relevant products or those that are in a position to enter the market. The Federal Reserve will also reconsider the importance of thrifts and other depository and nonbank financial institutions, such as credit unions and finance companies, in the market if the initial screening violates the HHI standards.

Measuring Market Concentration

After Justice has determined which participants to include in the market, they determine what weight to give the participants for the purpose of recalculating HHI. For example, Justice staff may include only a percentage of the deposits of the relevant thrifts to account for the thrifts' limited activity in commercial business. As we noted earlier, the Federal Reserve typically gives thrift deposits a 50-percent weight in calculating HHI, but thrift deposits may be included at a higher percentage if thrifts in the

¹⁹Middle market businesses are medium-sized businesses with annual revenues around the \$10 million-\$250 million range that have borrowing and cash management needs that exceed the capabilities of community banks.

market provide products and services similar to those provided by banks. Other institutions might also be given additional weight if their presence in the market is unusually important.

Other Considerations

If a merger fails HHI after these adjustments, Justice and the Federal Reserve will look beyond the HHI screen at other factors that might negatively or positively affect competition in a market.

Factors Negatively Affecting Competition

For example, to determine whether market conditions are conducive to market power, Justice and the Federal Reserve will consider the current nature and degree of competition in a market, including any information on pricing behavior and the quality of services provided. They will also consider the total market share of the merged bank and have indicated that when that market share exceeds 35 percent they review the merger carefully because at that level it becomes more likely that the bank unilaterally could exert market power.

Another issue that the Federal Reserve has on occasion considered when reviewing bank holding company mergers is the sequential acquisition of banking companies. In some instances when a banking company acquires several small banking companies, one at a time, the acquisitions, when assessed alone, do not violate the concentration standards. However, together these acquisitions have raised some questions as to their effect on competition.

Potential Mitigating Factors

The Federal Reserve and Justice also consider whether anticompetitive behavior will be prevented or remedied by the possibility that other competitors may enter the market. For potential competition to be considered a procompetitive factor, the market must be attractive for both de novo and out-of-market entry. Markets must also have low barriers to entry, potential acquisition targets, and meaningful potential entrants. Justice specifically considers whether entry (1) could occur within a "timely" period, (2) would be profitable and therefore "likely," and (3) would be sufficient to return prices to their premerger levels. The number of potential entrants generally increases as restrictions on in-state branching and interstate banking are lifted. In several merger cases in the last 5 years, the Federal Reserve found that potential competition was a significant factor in mitigating the anticompetitive effects of a merger and approved the merger even though the postmerger HHI was above the 1800/200 standard.

The recent merger of First Bank System, Inc., and Bank Shares, Inc., was such a case. This merger increased HHI by 317 points to 2026 in the Minneapolis-St. Paul banking market. However, the merger was approved by the Federal Reserve and was not challenged by the Department of Justice. The Federal Reserve said that "the Minneapolis-St. Paul banking market is a major urban area and, as such, is attractive for entry." The Federal Reserve noted that the market had experienced both de novo entry and entry by acquisition in recent years and that Minnesota had recently relaxed restrictions on interstate banking, which increased the number of potential entrants.

In other recent cases, Justice took into consideration whether firms currently operating in the relevant markets had the capacity and incentive to expand their output. If smaller market participants would be likely to expand output sufficiently, it would become more difficult for banks, either unilaterally or through collusion, to raise prices after a merger.

Justice also considers the potential efficiencies gained from a merger as a factor that could mitigate the anticompetitive effects of a merger. The Justice Department recognizes that efficiency gains from mergers can benefit consumers through lowered production costs, new products, improved services, and lower prices. However, to be considered a mitigating factor by Justice, the efficiencies gained from a merger must be achievable only through the merger and must outweigh the merger's potential adverse competitive effects. Justice relies on the merging parties to provide the evidence of efficiencies.

The anticompetitive effects of a proposed merger can also be mitigated if a firm is expected to fail in the near future, no other purchaser is available that would make the merger less anticompetitive, and the assets of the firm would exit the market if the acquisition were not allowed. It is important to note that if other purchasers are available to make the merger less anticompetitive, the Justice Department will not consider this "failing firm" defense to be a mitigating factor. For example, in the Fleet/Norstar acquisition of Bank of New England, the Department of Justice found that fewer anticompetitive alternatives were available and required Fleet/Norstar to make appropriate divestitures to resolve competitive problems in certain markets.²⁰

²⁰The Justice Department filed a civil antitrust suit to block this merger and Fleet/Norstar agreed to the divestitures and settled the suit. *United States of America v. Fleet/Norstar Financial Group, Inc.*, Civ. No. 91-0221-P (D. Maine 1991).

Finally, a declining market or other factors unique to a market or firm might also mitigate the anticompetitive effects of a merger. For example, if a market is declining economically, and it is determined that this decline is a long-term condition, a merger might be the most appropriate way for banks to exit the market.

Divestitures

After considering each of these factors, the Federal Reserve will make its final determination of whether to deny a merger on antitrust grounds, and the Department of Justice will decide whether to challenge a merger. Some mergers are allowed only after the applicant formally agrees to divest certain banking assets and deposits. When the merging banking companies have a significant presence in the same markets, significant divestitures might be necessary.

Divestitures are agreed upon by the acquiring banking company and the Federal Reserve and Justice. Once divestitures are agreed to, banking companies are required to abide by the agreement. For example, BankAmerica and Security Pacific overlapped in 114 banking markets in 7 states. They agreed to divest approximately \$8.5 billion in deposits, or about 6 percent of the merged institution's domestic deposits, in 74 geographic markets located in 5 states. BankAmerica agreed to divest branches, vault and operations facilities, deposits, and earning assets—particularly commercial loans.²¹ According to the Justice Department, the divestitures that BankAmerica agreed to in Seattle, Las Vegas, and Reno created a major new competitor with an extensive branch network and a significant competitive presence in middle market, small business, and retail banking and lending.²²

In some cases where the Federal Reserve has approved a merger but the Justice Department has filed suit to block it, banking companies have agreed to divest certain offices in order to settle the suit with the Justice Department. For example, in the Society-Ameritrust merger that was approved by the Federal Reserve, the Department of Justice filed suit to block the merger and simultaneously filed a settlement in which the parties agreed to divest 30 branches—assets and deposits—in Cuyahoga and Lake Counties in the Cleveland area. These divestitures included about \$40 million in small business loans. The final settlement also

²¹Specifically, in Arizona, BankAmerica agreed to divest, among other things, 49 branches; in California, 43 branches; in Nevada, 30 branches; in Oregon, 3 branches; and in Washington, 86 branches. In each case, BankAmerica agreed to divest commercial or consumer loans outstanding to borrowers whose primary deposit account relationship was with a divested branch.

²²In Arizona, the divestitures BankAmerica agreed to created the fifth largest bank in Arizona, replacing the retail banking competitor lost by the merger.

required that Society make all “reasonable efforts” to ensure the sale of the entire divestiture package to a single, independent purchaser.²³

There have been very few cases where the Department of Justice and the Federal Reserve have not been able to agree on solutions with the banks involved to prevent anticompetitive effects of bank mergers. In the past 5 years, the Department of Justice has filed suit to block banking company mergers in only five cases, and the Federal Reserve has denied only two mergers because of competitive concerns.²⁴ However, it is important to note that the number of disapprovals or formal objections raised by each agency by no means fully reflects the influence of antitrust enforcement. The antitrust enforcement of the Federal Reserve and the Justice Department has most certainly discouraged some potential bank mergers before the applications were ever filed and has resulted in divestitures to avoid litigation.

Antitrust Enforcement Appears to Have Prevented Some Anticompetitive Mergers, but Continued Oversight Is Necessary to Ensure Competitive Markets

Antitrust enforcement has been important in ensuring that local banking markets remain competitive, despite record consolidation in the banking industry. Both the Department of Justice and Federal Reserve follow a deliberate process of antitrust enforcement. They each take an active role in screening all mergers and investigating those with the potential to adversely affect competition. Their antitrust enforcement appears to have prevented some anticompetitive mergers and has helped to ensure that the average concentration levels in local banking markets—both urban and rural—have remained relatively stable during the 1980s.

In addition the characteristics of many local markets indicate that the application of antitrust statutes will continue to be important in future mergers. For example, the median HHI is just slightly above the 1800 HHI standard in urban areas and well above that standard for most rural markets. Eight of the 46 metropolitan statistical areas with populations of

²³United States v. Society Corporation, and Ameritrust Corporation, 1:92CV 0525 (D. Ohio 1992).

²⁴The Department of Justice filed suit to block mergers in the following cases: United States of America v. First Hawaiian, Inc., and First Interstate of Hawaii, Inc., Civ. No. 90-00904 (D. Hawaii 1991); United States v. Fleet/Norstar Financial Group, Inc. Civ. Docket No. 91-0221-P (D. Maine 1991); United States v. Society Corporation and Ameritrust Corporation, 1:92CV 0525 (D. Ohio 1992); United States v. Texas Commerce Bancshares, Inc., and Texas Commerce Bank-Midland, N.A., 3-93CV02494-6 (D. Texas 1993); United States v. Texas Commerce Bancshares, Inc., and Texas Commerce Bank-Beaumont, N.A., 3-93CV0308-D (D. Texas 1993).

The Federal Reserve Board denied SouthTrust Corporation's application to acquire First Federal Enterprises, Inc. (Federal Reserve Bulletin, Sept. 1992) and Norwest Corporation's application to acquire First Federal Savings Bank of South Dakota (Federal Reserve Bulletin, June 1992).

more than 1 million have HHIs above the 1800 standard. Although these data most likely overstate the concentration levels to some extent because they do not account for thrifts or other competitors and may not correspond exactly to geographic market definitions used in actual bank merger analysis, they still demonstrate that future in-market merger activity will likely cause competitive concerns.

To ensure that banking markets remain competitive in the future, careful enforcement of the antitrust laws will be needed—whether or not restrictions on interstate banking are lifted. Indeed, market concentration concerns may be more immediately apparent if geographic barriers to nationwide banking are not lifted. Yet nationwide banking may raise some unique antitrust concerns, specifically related to national and regional markets and to the potential spurt in consolidation that permitting nationwide banking may encourage. Furthermore, enthusiasm over deregulation could lead to a relaxation in antitrust enforcement in the banking industry.

While the broad nature of the antitrust statutes and Merger Guidelines provide the flexibility to address a wide range of antitrust concerns, this very characteristic requires a significant degree of judgment in the enforcement of the statutes. The inherently judgmental nature of certain key aspects of the antitrust process emphasizes the need for congressional oversight and raises concerns about some issues, including

- the differences in methodology between the Federal Reserve and the Justice Department for defining the product markets,
- the basis for considering national and regional concentration levels in certain situations,
- the treatment of problem banks,
- policies toward divestitures,
- follow-up of merger approvals that exceed the HHI screen, and
- acquisitions of small banks.

Defining the Relevant Product Markets

The appropriate definition of product markets in antitrust enforcement is an issue of potentially great significance to bank customers and, of course, the banks as well. The definition of product markets is of particular relevance to small businesses, given the importance of small businesses to the economy and their dependence on local banks for financing.

The language in section 7 of the Clayton Act requires that bank competition be assessed in terms of the appropriate product and geographic markets in the banking industry. In the 1963 Philadelphia National Bank case we discussed earlier, the court accepted the evidence and analysis presented to it that the relevant geographic market in commercial banking was a local area and that the relevant product market was represented by the cluster of banking products and services. Court cases since the Philadelphia case have upheld the basic market definition concepts laid out in the case. However, the courts have indicated a willingness to consider arguments that commercial banking services are not a single product line if the facts support a departure from the market definitions as they were laid out in the Philadelphia National Bank case. An example of a case rejecting an alternative market definition because of insufficient evidence was the 1987 case against Central State Bank.²⁵ In that case, a court of appeals upheld a lower court's decision that the cluster of banking services was the relevant product market because the government failed to factually support its claim that the circumstances in the case warranted a departure from the traditional cluster of products and services market definition. While the court found the cluster of services was the appropriate market definition in this case, its analysis underscored the factual nature of this inquiry.²⁶

The approach taken to define a product market is important because the degree of antitrust protection that exists for particular sectors of the economy, such as small business, depends on the product market definition. Depending on the product market definition, the concentration analysis and resulting competitive concerns may differ significantly. For example, by focusing on a more specific product line, rather than on the cluster of services for all banking customers, the Department of Justice staff may determine that the relevant geographic market is either smaller or larger than the Federal Reserve market and include different banking and thrift organizations in their analysis than would the Federal Reserve.²⁷

²⁵United States v. Central State Bank, 817 F.2d 22 (6th Cir. 1987).

²⁶In this case, the Department of Justice proposed to treat transactions accounts and small business loans as separate product lines.

²⁷For example, when Society Corporation and Ameritrust Corporation merged, the Department of Justice analysis defined the geographic market more narrowly than did the Federal Reserve. The Department of Justice's analysis determined that the relevant product market was nonreal estate loans to small businesses. They also determined that small businesses in the Cleveland market were not likely to receive loans beyond their home counties. Therefore, Justice staff concluded that the Cleveland metropolitan market, as defined by the Federal Reserve, was too large and should be divided into two markets.

The Justice Department staff may also determine that thrifts play a larger or smaller role in providing the products or services in the relevant product market and weight them accordingly. For example, if the relevant product market is loans to small businesses and Justice staff determine that the thrifts in the area do not provide loans to small businesses, those thrifts will not be treated as participants in the market. Justice may, however, consider the role of other financial services providers not specifically included by the Federal Reserve under its cluster of services approach to defining a product market.

Although the differences in the Federal Reserve's and the Department of Justice's approaches to defining product markets have not affected the outcome of many mergers to date, the differences are likely to become more important in the future if local markets become more concentrated and HHI standards are tested more frequently. In addition, these differences have caused confusion among banks and industry analysts, and both approaches have been criticized. Some critics have said that the cluster of banking products and services is no longer the relevant market for assessing bank mergers and that the Department of Justice's approach more closely fits economic reality. Federal Reserve officials have responded that product market definitions must be based on empirical evidence and that it is not clear, at this point, that systematic empirical evidence exists that would justify breaking up the cluster into separate product markets.

Some Federal Reserve officials are also cautious about adopting a more specific product line approach because they believe it might create greater uncertainty for banks intending to merge. For example, without general empirical evidence regarding product market definitions, it would not always be possible for Federal Reserve staff to provide applicants with an assessment of likely competitive concerns early in the processing of an application. Nevertheless, these problems could be minimized if bank regulators and Justice staff clearly describe and make public their methodologies for assessing bank mergers.

Another practical problem with the Justice Department approach is a lack of readily available data. For example, when Justice staff have determined that nonreal estate loans to small businesses is the relevant product market, they would ideally measure each bank's share of nonreal estate commercial loans extended to small businesses and use these shares to calculate HHI levels. These data, however, are not routinely collected and

are very difficult to obtain on a bank-by-bank basis in particular geographic areas.²⁸

The Justice Department's approach to defining markets is also very time-consuming because Justice may rely on interviews with potential suppliers and consumers of the relevant product. In addition, Federal Reserve officials said they cannot gather as much information as the Justice Department because they do not have Justice's civil investigative demand powers and therefore cannot demand information from banks not involved in the merger or from other firms in the market. Nevertheless, Federal Reserve officials agreed that the approach taken by the Justice Department should not be dismissed and that it has some intuitive appeal from a theoretical economic perspective.

National and Regional Markets

Some industry observers have expressed a concern that lifting restrictions on interstate banking and branching will create a significant increase in concentration at the national or regional level, particularly if banks adopt a "gold rush" mentality. Although the Federal Reserve's safety and soundness standards may be sufficient to discourage any hastily conceived mergers of out-of-market banks, it is unlikely that interstate mergers will raise antitrust concerns. This is particularly true under the Federal Reserve's antitrust analysis because national and regional markets are very unconcentrated—as measured by HHI—and there are currently few banking companies that overlap in local markets in different states. As we mentioned earlier, the Federal Reserve's analysis focuses only on local markets because it defines the relevant product market as the cluster of all banking products and services. In certain cases, the Federal Reserve expanded its cluster approach, on an ad hoc basis, to consider separately the competitive effects of activities that may have national or regional markets.

The Justice Department framework for defining product markets is more easily adapted to assessing the competitive effects of mergers on national or regional markets because it can include definitions of relevant markets by product line. In some merger investigations, Justice staff have based their analyses on product markets with regional or national geographic markets—such as loans to middle market businesses or government securities clearing activities.

²⁸In at least one case, Justice has approximated the share of total commercial loans each banking organization in the market makes to small businesses and then used this information to estimate the banking organization's market shares and the market concentration levels.

Problem Banking Company Resolutions

Conflicting safety and soundness and antitrust goals may also raise concerns about the adequacy of the banking agencies' antitrust reviews, particularly when the mergers involve failed or failing banking companies. Officials at the Federal Reserve and FDIC acknowledged that they have to balance the goals of ensuring a safe and sound banking system, protecting BIF, and maintaining competitive markets. To do this sometimes means allowing mergers that might not be allowed if only the competitive effects of mergers were considered.

The Federal Reserve has approved mergers that have resulted in concentration levels that exceeded its standards while not always accepting the least anticompetitive bid. In the failed Bank of New England transaction, the Federal Reserve approved the bid of an in-market institution even though out-of-market bank holding companies had also bid on the Bank of New England. A Federal Reserve official said that accepting one of the other bidders would have been very expensive to BIF. In this case, the Justice Department filed a suit to block the merger unless the acquiror, Fleet/Norstar, agreed to certain divestitures. The acquiror agreed to the Justice Department's terms, and the suit was settled. An official at the Federal Reserve also told us that there have been cases in which the staff were concerned about denying a merger application for a troubled bank or thrift because a denial might discourage other firms from bidding on failed banks or thrifts in the future.

On the other hand, the Federal Reserve denied Norwest Corporation's application to acquire a troubled Resolution Trust Corporation-controlled thrift, First Federal Savings Bank of South Dakota, because Norwest's market share after the acquisition would have violated the concentration guidelines. In this case, unlike in most assisted thrift acquisitions, there were alternative bids for the thrift that would not have resulted in an increase in concentration, and the Federal Reserve decided that the extra cost to the Resolution Trust Corporation of accepting the second-best bid for the troubled thrift was outweighed by the anticompetitive effects of allowing Norwest to acquire the thrift.

Divestiture Policy

Although both the Department of Justice and the Federal Reserve believe that targeted divestitures of branches or certain other banking operations are important to ensure that markets remain competitive after bank mergers, they have somewhat different approaches to divestitures. These different approaches make it difficult for banking companies that are applying to merge to predict what divestitures will be necessary. The

Federal Reserve will generally approve mergers if the divestitures bring the postmerger concentration below the 1800/200 HHI screen, accepting this measure as an acceptable level of concentration. In addition, the Federal Reserve generally permits the acquiring bank to determine which branches to divest in order to meet the concentration standard.

The Justice Department, on the other hand, examines the specific branches and assets proposed for divestiture to ensure that the divestiture will alleviate any anticompetitive concerns. The Justice Department's goal is to ensure that the divestitures replace the competition lost through the merger.²⁹ Justice officials said that the Federal Reserve's policy will not necessarily replace this lost competition. For example, Department of Justice officials may require that certain divested deposits or assets go to a new entrant to the market rather than to an existing bank in the market. In addition, Justice officials said that while divesting a branch located on the outer fringe of a market may decrease HHI so that it falls within the standard, it may be unlikely to restore competition in the market. The Federal Reserve, however, believes that if the market definitions are correct, it should not matter which branches are divested in a market.

Follow-Up

As we mentioned earlier, bank merger analysis is not an exact science but requires some judgment that might be influenced by the philosophical leanings of Justice Department staff and Federal Reserve officials and staff. The need for judgment is particularly evident with regard to factors that might mitigate the anticompetitive effects of mergers in highly concentrated markets. However, neither the Federal Reserve nor the Department of Justice devotes any resources to assess the validity of the specific judgments that led to the approval of mergers that exceeded the HHI screen, although Federal Reserve economists do study related issues.

For example, in cases where the Federal Reserve has cited the possibility of entry as a reason for approving mergers in highly concentrated markets, no work has been done to determine whether potential entry has been a factor in ensuring competitive banking markets after the mergers. Neither have Justice nor Federal Reserve staff followed up on markets where divestitures have been necessary for approval of a merger to help determine whether the current divestiture policies are sufficient to replace the competition lost through mergers.

²⁹For example, in the recent BankAmerica-Security Pacific merger, Justice required that the divestitures in the Seattle area create a major competitor in middle market lending that would leave the market substantially as competitive as it was before the merger.

Acquisitions of Small Banks

The enforcement of antitrust laws generally will not protect small banks from being acquired by large banks because antitrust policy focuses on market power, not the size of banks in a market.³⁰ Acquisitions of small banks by much larger ones would rarely exceed the HHI screen for potential market power because it would be extremely difficult for such an acquisition to result in a 200-point increase in HHI. For example, a large bank with a 20-percent share of a market could sequentially acquire 4 small banks, each with a 2-percent share of the market, and HHI would increase by only 80, 88, 96, and 104 points, respectively, never exceeding the screen. On the other hand, an acquisition of a single bank with an 8-percent share of the market would increase HHI by 320.

The Federal Reserve told us that in the past it has examined the effect of sequential mergers on market power and pricing in already concentrated markets even when the mergers individually did not violate the HHI screen, as noted earlier. This concern, however, has little to do with the specific number of small banks in a market but focuses on the acquiring banking company. If markets are not concentrated, the Federal Reserve would not be concerned by a significant number of small bank acquisitions or by decisions of the acquiring banks to stop offering certain banking services—such as loans to small businesses—that the acquired banks had provided. These issues are not relevant to the market power concerns of antitrust analysis.³¹ They would have to be addressed outside of the antitrust process and may merit congressional oversight if the future viability of small banks is called into question.

Conclusions

It is difficult to predict how lifting restrictions on interstate banking will affect the concentration of banking markets. At the national level, a significant amount of consolidation could occur before antitrust concerns would become a factor. At the local market level, nationwide banking may reduce concerns about market power in the short to medium term if banking companies expand into new markets rather than continue consolidating in markets in which they already have a significant presence. Yet over time, as banking companies develop a more nationwide presence,

³⁰As we discussed earlier, there is one exception to this general rule. If a merger results in a banking organization with at least a 35-percent share of the market, both the Federal Reserve and the Department of Justice will examine the merger more closely to determine whether it may create market power.

³¹In a free market economy, business strategies are not dictated by regulation unless an overwhelming public good is involved. In such cases, laws or regulations are passed to specifically address the identified needs. CRA is an example of such a public policy tool.

the extent of local market overlaps that might create competitive concerns is likely to increase.

Whether or not restrictions are lifted on interstate banking, careful enforcement of antitrust laws is essential to ensure that banking markets remain competitive in the future. While the language of the antitrust laws is sufficiently broad to provide the authority to address the potential local and national market competitive concerns associated with nationwide banking and branching, how the concerns are addressed depends on the enforcement of the statutes. Because this enforcement requires a greater degree of legal and economic judgment compared with other areas of banking regulation, its adequacy, to a certain extent, depends on the philosophical leanings of the officials charged with enforcement responsibilities.

Because of the judgment involved in assessing the competitive effects of bank mergers, differences have emerged in the analyses of the Federal Reserve and Department of Justice. While the differences have not affected the outcome of many mergers, they are likely to become more important in the long term if local markets become more concentrated, the HHI standards are tested more frequently, or if large banking companies merge more frequently. Ensuring protection in the future against anticompetitive effects of mergers will require staff at the banking agencies and the Department of Justice to continue to work to get the best possible data and to ensure that they are as well informed as possible when assessing the competitive impact of mergers. Nevertheless, there will be considerable latitude for judgment to be applied in final merger decisions regardless of the data and staff analysis. Because this judgment could be affected by internal policy goals at both the Federal Reserve and the Department of Justice, congressional oversight of antitrust enforcement is important. Such oversight will be important whether or not federal interstate banking and branching laws are liberalized because a considerable amount of consolidation is possible under current federal restrictions.

Influences Shaping the Banking Industry's Structure

To assess the possible effect of removing interstate banking and branching laws, it is necessary to have a clear understanding of the structure of the banking industry. In this appendix, we discuss the influences that have shaped the industry's structure. Many factors have contributed to recent changes that have occurred in the structure of the banking industry, including changes in branching laws, the bank holding company structure, special provisions in federal laws, interstate compacts, bank failures, the economies of bank mergers, and the presence of foreign-owned banks.

Branching Laws

Before the National Currency Act of 1863 authorized the chartering of national banks and created the dual banking system, most banks were chartered individually by state legislatures. As a result, branching authority often varied from bank to bank but not necessarily from state to state. Although the National Currency Act and its successor, the National Bank Act of 1864, did not specifically mention branching, they were interpreted by the courts as prohibiting branching by national banks. This interpretation created inequities between nationally and state-chartered banks because some state-chartered banks were allowed to branch while national banks were not.

In 1927, Congress passed the McFadden Act, which—contrary to common belief—liberalized branching rights for national banks by permitting them to branch within their home cities if state-chartered banks were allowed to do so. Congress further liberalized the abilities of national banks to branch when it passed the Banking Act of 1933, authorizing national banks to establish branches in any location state law allowed state banks to branch.¹ The primary significance of the Banking Act of 1933, however, was to give states, not the federal government, the authority to legislate the branching structure for both national and state-chartered banks within a state's territory.

The branching laws that states passed fell into three categories—those prohibiting branching (unit banking states); those allowing limited branching, generally within geographic limits such as a county or city; and those allowing unrestricted branching within states' borders. Most states passed statutes restricting branching in some way. And while many states liberalized their branching laws over time, 12 states still prohibited any form of branching in 1979.²

¹A branch was defined as an office of a bank that receives deposits, pays checks, or lends money.

²In 1979, the unit banking states were Colorado, Illinois, Minnesota, Kansas, Missouri, Montana, Nebraska, North Dakota, Oklahoma, Texas, West Virginia, and Wyoming.

In the intervening years, these 12 states repealed their laws prohibiting branching. Thus, no unit banking states remain, and only 13 states continue to limit branching in some way.³ The industry's experience with large numbers of bank failures in the 1980s contributed to this liberalization of in-state branching laws. It is generally believed that banks in unit banking states were more vulnerable to economic downturns because they were restricted from diversifying geographically. The Federal Deposit Insurance Corporation (FDIC) has also been supportive of liberalized branching laws in an effort to make failed banks more attractive to potential purchasers.

The effect of restrictive state branching laws on the structure of the banking industry is readily apparent. In 1986, before it repealed its unit banking law and before massive bank failures, Texas domiciled 1,972 banks—about 14 percent of the total number of banks in the United States. Illinois, another state that severely restricted branch banking, had 1,221 banks in 1986, almost 9 percent of the total number of banks in the United States at the time. By contrast, California, a state with a long history of statewide branch banking, had 484 banks, and New York had 200 banks.

Bank Holding Companies

Banking companies were able to overcome in-state branching restrictions by forming multibank holding companies. By 1956, the expansion of bank holding companies—both into different locations and different product lines—had created concern in many quarters about the concentration of economic power among a relatively small number of large banking institutions. This concern about the potential to exert undue influence over the allocation of financial resources prompted the passage of the Bank Holding Company Act of 1956.

The act was the first federal legislation to focus solely on the multibank holding company form of organization and included many provisions governing bank holding companies. It gave the Federal Reserve the responsibility for supervising multibank holding companies⁴ and restricted the degree to which multibank holding companies could be affiliated with

³Of the 13, 8 (Colorado, Illinois, Minnesota, Montana, Nebraska, North Dakota, Oklahoma, and Wyoming) had been unit banking states in 1979. The other five that limit in-state branching are Arkansas, Georgia, Indiana, Iowa, and Kentucky.

⁴The Federal Reserve usually relies on the appropriate bank regulatory agency to supervise the bank when the bank involved is a national bank—the Office of the Comptroller of the Currency (OCC)—or a nonmember state bank—FDIC. In the same manner, the Securities and Exchange Commission regulates the securities subsidiaries of bank holding companies, such as section 20 firms and discount brokers, and the Commodities Futures Trading Commission regulates bank holding company subsidiaries that fall under its jurisdiction.

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(i.e., own or be owned by) industrial and other nonbanking companies.⁵ In 1970, the Bank Holding Company Act was extended to cover one-bank holding companies.

Although the act restricted bank holding companies in some ways, it permitted them to establish nonbank subsidiaries and offices that carry out a variety of activities provided that these activities are "so closely related to banking or managing or controlling banks as to be a proper incident thereto." The Federal Reserve was given the authority to determine these "closely related" activities and has authorized many by regulation and order. Subsidiaries that are permitted under section 4(c)(8) of the Bank Holding Company Act include mortgage corporations, finance companies, brokerage firms, and data processing firms.

The Federal Reserve estimated that as of December 31, 1992, consolidated bank holding company assets totaled \$2.7 trillion, of which 6.7 percent, or \$181 billion, was accounted for by nonbank subsidiaries and the parent. Among the larger bank holding companies, there is not much variation in nonbank assets as a percentage of total assets. Two of the 25 largest bank holding companies have more than 20 percent of their assets in nonbank assets, while 19 have less than 10 percent in such assets (see table I.1).

Table I.1: Nonbank Assets as a Percentage of Total Bank Holding Company Assets for the 25 Largest Bank Holding Companies

Nonbank assets/total bank holding company assets	Number of bank holding companies
20%-50%	2
10%-20%	4
1%-10%	19
0	0

Note: Data are for the period ending September 30, 1992.

Source: Federal Reserve data.

The act also included section 3(d), known as the Douglas Amendment, which prohibited bank holding companies from acquiring or chartering a bank in another state unless such actions were specifically permitted by

⁵In general, bank holding companies may not own or be owned by industrial or other nonbanking organizations. However, the Bank Holding Company Act does allow bank holding companies to purchase up to 5 percent of the stock of any corporation as long as it is a noncontrolling interest. It is our understanding that bank holding companies have generally not taken advantage of this provision because of liability concerns associated with owning stock in companies to which they also make loans.

the state into which the bank holding company wished to enter.⁶ The Douglas Amendment thus added control over interstate banking to the in-state branching authority previously given to states. Nonetheless, because no state moved to permit interstate expansion until years later, banking companies were effectively blocked from further interstate activity through full-service bank subsidiaries. Those bank holding companies that had already crossed state borders when the act was enacted were allowed to keep their interstate bank subsidiaries but were not allowed to expand into additional states.⁷

The Douglas Amendment did not restrict interstate expansion through nonbank section 4(c)(8) subsidiaries because they do not meet the lending and deposit gathering criteria that would define them as banks. Consequently, even before states moved to permit interstate banking beginning in the late 1970s, bank holding companies could expand across state lines through their section 4(c)(8) subsidiaries. The Federal Reserve estimated that by 1988 bank holding companies owned approximately 6,500 interstate section 4(c)(8) subsidiaries.⁸

Special Provisions in Federal Laws

Additional avenues for interstate expansion authorized in federal laws have contributed to the multistate presence of many banks and bank holding companies. These include nonbank banks, Edge Act Corporations, and loan production offices.

Before 1987, the Bank Holding Company Act defined a bank as an institution that made commercial loans and accepted demand deposits. Several bank holding companies, nonbank financial institutions, and commercial firms took advantage of this definition to establish subsidiaries that engaged in only one of these activities. Concern about the rapid increase in nonbank banks that accepted deposits insured by FDIC prompted the passage of a provision in the Competitive Equality Banking Act of 1987 that changed the definition of banks' eligibility for deposit insurance. However, the existing ones were grandfathered.

⁶The term bank was defined as any institution that both accepted demand deposits and made commercial loans.

⁷The grandfathered holding companies included seven U.S. holding companies—Western Bancorporation, First Bank System, Northwest Bancorporation, Otto Bremer Foundation, Financial General Bancshares Inc., General Bancshares Corporation, and First Security Corporation—and five foreign banking organizations—Bank of Montreal, Canadian Imperial Bank of Commerce, The Bank of Tokyo, Ltd., Barclays Bank Limited, and The Sumitomo Bank, Limited.

⁸Most recent number available.

Since 1919, banks have been permitted to establish Edge Act Corporations outside their home states to provide services related to international transactions. According to the Federal Reserve, 94 Edge Act Corporations of U.S. banks had about \$30 billion in assets at the end of 1992.

Banks may also maintain loan production offices, which allow them a lending presence outside of their home state. As of 1988, banks had established 332 loan production offices.⁹

Interstate Banking Laws

Until 1978, no state took advantage of its ability under the Douglas Amendment to permit out-of-state acquisitions of its banks. Effective that year, the state of Maine permitted the entry of out-of-state bank holding companies on a national reciprocal basis, i.e., allowing the entry of bank holding companies from any state that also permitted bank holding companies headquartered in Maine to enter. There was no further state action until 1982 when Alaska and New York passed interstate banking laws.

In 1982 and 1983, the development of interstate banking took off when the New England compact was established. Massachusetts, Connecticut, and Rhode Island initially participated in the compact. Each of the states passed laws permitting interstate entry from other New England states on a reciprocal basis. The Supreme Court upheld the exclusive nature of the compact in 1985, a decision that contributed significantly to the acceleration of interstate banking through regional compacts. In 1985, of the 24 states and the District of Columbia with interstate banking laws, at least 15 belonged to regional compacts.¹⁰

States with reciprocal laws generally fell into the following broadly defined regions: the West, New England, the Southeast, and the Midwest.¹¹ Most of these regional compacts were viewed as a means of fostering the growth of banking companies within their areas while barring competition from large money center banks in New York and other large bank holding

⁹Most recent number available.

¹⁰The term compact is used relatively loosely in describing regional reciprocal banking laws. Each state passed regional interstate statutes identifying the states to which it would grant reciprocity. There is no single regional interstate law or a regional agreement among the states in a region to which all adhere. Regional definitions also vary. For example, the states in the Southeast and those in the Midwest sometimes vary widely in the states within their region to which they have granted reciprocity.

¹¹Each state determined the states it wished to include in its region. Consequently, the members of any regional compact were not exactly defined.

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companies from states such as California and Texas. Consequently, these states generally were not included in regional reciprocal agreements.

These regional compacts were successful in fostering the rise of regional banking and the creation of large regional and superregional banks. For example, even though Citicorp still heads the list of the largest bank holding companies, about one-half of the top 20 bank holding companies in the United States were developed largely through interstate acquisitions in states belonging to regional compacts (see table I.2).

Table I.2: Superregional Bank Holding Companies Among the 20 Largest U.S. Bank Holding Companies

Dollars in billions			
Name (headquarters state)	Rank 1992	Assets	Asset growth rate (1986-92)
BankAmerica (California)	2	\$180.6	73.3%
NationsBank (North Carolina)	4	118.1	329.5
Banc One (Ohio)	8	61.4	252.9
Wells Fargo (California)	9	52.5	17.7
PNC Financial (Pennsylvania)	10	51.4	90.4
First Union (North Carolina)	11	51.3	90.7
First Interstate (California)	12	50.9	-8.1
Fleet Financial Group (Rhode Island)	14	46.9	300.9
Norwest Corp. (Minnesota)	15	44.6	107.4
NDB Bancorp (Michigan)	16	40.9	77.1
Bank of New York (New York)	17	40.9	97.6
Barnett Banks (Florida)	18	39.5	95.5
SunTrust Banks (Georgia)	20	36.6	39.7

Note 1: Superregional banks and 1992 rankings as designated by American Banker.

Note 2: Data are for the period ending December 31, 1992.

Source: Federal Reserve data and American Banker.

The liberalization of interstate banking laws has continued unabated since 1985. By early 1993, all but two states, Montana and Hawaii, permit some form of interstate banking.¹² Although most states originally took a regional approach to interstate banking, by December 31, 1992, a majority of states had opened their doors to bank holding companies from any state, either on a reciprocal or nonreciprocal basis as follows:

¹²Montana has banks grandfathered under the Douglas Amendment and passed legislation permitting regional reciprocal banking that took effect October 1, 1993.

- Thirteen states and the District of Columbia allow entry by bank holding companies from any state (nationwide).
- Twenty-one states allow entry by bank holding companies from any state that reciprocates states this privilege (nationwide reciprocal).
- Only 14 states still restrict interstate entry to bank holding companies from their own geographic region (regional reciprocal).¹³ Regional reciprocal banking predominates primarily in the southeastern central, and north central United States. The New England and West state compacts no longer exist as all of the states originally in those compacts have since adopted nationwide or nationwide reciprocal laws.

The speed with which states passed interstate laws may be attributed to several factors. Some states hoped that interstate banking would promote economic development—either through the entry of new capital or as a result of the creation of large regional banks that would promote economic growth. Also, states hoped that allowing interstate entry would increase the number of potential acquirors of troubled banks. Finally, some argued that interstate banking should be permitted if only to formalize the de facto interstate activity of bank holding companies through nonbank subsidiaries.

Among the reasons cited for the liberalization of interstate laws are that it would (1) place banks on a more even competitive basis with other financial services firms, (2) enable banks to keep up with those in states that already had such laws, and (3) enable bankers interested in selling their banks to obtain higher bids.

Interstate banking laws are far from uniform even within the three categories—regional reciprocal, nationwide reciprocal, and nationwide—we described earlier. Some reasons for the differences are as follows:

- **Regional definitions.** Several states belonging to the same regional compact define the states belonging to that region differently.¹⁴

¹³Montana enacted regional reciprocal legislation that took effect October 1, 1993, which brings the number of regional reciprocal states to 15.

¹⁴Some states are excluded from the region by others in the region, while other states belong to two regions. In general, to qualify as a holding company from a specific region, the holding company must have at least 80 percent of its total deposits in states within that region. Up to 20 percent of the holding company's deposits may be in bank subsidiaries outside of the region. If a bank holding company ceases to qualify as a regional holding company, it must divest itself of some of its assets outside of the region, generally within 1 or 2 years.

- **Types of acquisition.** Most laws permit entry only through acquisition, and some restrict acquisitions to institutions that have been in existence for a minimum number of years. However, at least 17 states allow de novo entry. Some states also restrict the percentage of the state's deposits that can be held by any single bank holding company. But these restrictions vary from 10 percent of deposits in Iowa to 30 percent in Minnesota.
- **An opt-out.** Several states allowed in-state banks to opt out of interstate activity for a certain period of time. If a bank opts out, it is not allowed to acquire banks out of state or to be acquired by out-of-state bank holding companies.
- **Economic development criteria.** Some states require bank holding companies that acquire in-state banks to contribute to the states' economic development. Maine, for example, requires acquiring bank holding companies to bring new capital into the state. Arkansas requires a plan for meeting the credit needs of small businesses and individuals in the communities affected by acquisitions.

Bank Failures

Record numbers of bank failures that occurred between 1986 and 1992 accelerated banking industry consolidation and contributed to the interstate presence of many bank holding companies. Between January 1986 and December 1992, 1,194 banks, of which the vast majority were banks with assets of less than \$1 billion, failed. Only 33 had assets of more than \$1 billion, while 809 had assets of less than \$50 million. Fifty-four, mostly large banks received FDIC assistance in these years (see table I.3).

Table I.3: Bank Failures for 1986-92

Dollars in billions		
Size of bank	Number of failures	Total assets
\$5 billion or more	8	\$84.2
\$1 billion-\$5 billion	25	50.0
\$500 million-\$1 billion	31	20.8
\$100 million-\$500 million	172	39.0
\$50 million-\$100 million	149	10.6
Less than \$50 million	809	16.5
Total	1,194	\$221.0

Note: Failures include 54 assistance transactions.

Source: FDIC data.

**Appendix I
Influences Shaping the Banking Industry's
Structure**

Acquisitions of failed banks have provided a vehicle for bank holding companies to increase their interstate holdings. The Garn-St Germain Act of 1982 permitted out-of-state bank holding companies to acquire large, failed commercial banks and insured mutual savings banks. The Competitive Equality Banking Act of 1987 liberalized and extended those provisions and authorized FDIC to arrange interstate takeovers of institutions with assets of more than \$500 million. In addition, some states enacted their own laws allowing out-of-state banks to acquire failing in-state institutions. The Garn-St Germain Depository Institutions Act of 1982 also allowed banks to acquire failed banks and thrifts, and a number have expanded by doing so.

Some of these acquisitions have contributed substantially to the growth of several regional bank holding companies. North Carolina-based NCNB, now NationsBank, entered into an agreement with FDIC to acquire First Republic in July 1988. At the time, First Republic had approximately \$26.8 billion in assets; NCNB reported assets of \$28.6 billion on June 30, 1988. When NCNB acquired controlling interest of First Republic during the third quarter of 1989, its assets increased to \$59.7 billion. When Banc One acquired MCorp, the Texas banking company, in 1989, it became the largest bank in Banc One's organization (see table I.4).

Table I.4: 12 Largest Interstate Acquisitions of Failed Banks and Thrifts

Dollars in billions

Acquiring bank holding company	Asset size at time of acquisition	Failed bank/thrift	Asset size	Year of approval
NCNB Corporation	\$28.6	First Republic Bank	\$26.8	1988
Fleet/Norstar	32.6	Bank of New England	13.6	1991
Banc One Corporation	25.1	MCorp Bridge Bank	12.0	1989
Security Pacific	86.5	Gibraltar Savings	5.1	1990
BankAmerica Corporation	115.5	Sunbelt Federal Savings Bank	3.8	1992
BankAmerica Corporation	106.4	Mera Bank Federal Savings Bank	3.5	1990
Chase Manhattan	98.5	City Trust/M&F Savings Bank	2.6	1991
UST Corporation	2.5	Home Owners Savings Bank	2.3	1990
BankAmerica Corporation	104.0	Ben Franklin Federal Savings & Loan	2.2	1990
BankAmerica Corporation	101.1	Western Savings & Loan Association	2.2	1990
Banc One Corporation	37.9	Bright Banc Savings	2.2	1990
Equimark Corporation	3.5	National Bancshares	2.2	1989

Note: Data are for the period ending January 1, 1993.

Source: Federal Reserve data.

Mergers

The consolidation of banks within bank holding companies has also contributed significantly to changes in the banking industry's structure since 1985. A number of bank mergers between 1985 and 1991 occurred when states liberalized their in-state branching laws. The 10 states that experienced the largest numbers of bank mergers between 1985 and 1991 liberalized their branching laws at some point during those years.¹⁵

The liberalization of interstate banking laws also contributed to the extent and pace of bank consolidation. While 5 of the 10 largest mergers from 1985 through 1992 occurred between bank holding companies headquartered in the same state, all but 2—Wells Fargo-Crocker and Bank of New York-Irving—involved significant expansion of an interstate presence (see table I.5).

Table I.5: 10 Largest Bank Holding Company Mergers for 1985-92

Dollars in billions		
Acquiror/target	Assets of the target	Year
BankAmerica Corporation-Security Pacific	\$76.4	1992
Chemical Banking-Manufacturers Hanover	65.6	1991
NCNB Corporation-C&S/Sovran Corp.	49.6	1991
NCNB Corporation-First Republic Bank	26.8	1988
The Bank of New York-Irving Bank	25.6	1988
Citizens & Southern-Sovran Financial	25.4	1990
Chemical New York-Texas Commerce Bancshares	19.2	1987
Wells Fargo Co.-Crocker National	19.2	1986
Republic Bank Corp.-interfirst Corp.	16.7	1987
Shawmut National Corp.-Hartford National	13.8	1988

Source: Federal Reserve data.

Foreign-Owned Banks

In a few states, bank subsidiaries of foreign banking companies play as large a role, if not a larger one, than out-of-state banks owned by U.S. bank holding companies. Because much of the debate about interstate banking centers around how out-of-state-owned banks might affect local economies, it is important to include foreign-owned banks in our examination of interstate bank expansion.

¹⁵The 10 states are Texas, Missouri, Florida, Illinois, Michigan, Wisconsin, Minnesota, Alabama, Georgia, and Indiana.

Until 1978, foreign-owned banks were not limited to a banking presence in one state, as were U.S. banks. To eliminate this competitive advantage, the International Banking Act of 1978 prohibited foreign-owned banks from expanding in ways not permitted to domestic banks. Foreign organizations were required to choose one state in which they would own a bank or holding company and operate according to the laws of that state. As was the case for U.S. banking companies, however, foreign-owned banks that already had interstate networks were allowed to keep them. In addition, foreign-owned banks and their bank subsidiaries may also establish Edge Act Corporations and maintain limited service interstate operations through branches and agencies.

As of December 1992, 85 bank subsidiaries owned by foreign banking companies controlled almost \$162 billion of banking assets in the United States. These bank subsidiaries are concentrated in New York, California, and Illinois (see table I.6). Each of these states has more of its banking assets controlled by foreign-owned banks than by out-of-state U.S. banking companies. Foreign-owned banks are also located in seven other states and the District of Columbia. In addition, there were 578 foreign branches and agencies.

**Appendix I
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**Table I.6: Location, Number, and
Assets of Bank Subsidiaries Owned by
Foreign Banking Companies**

Dollars in millions

States	Foreign-owned bank subsidiaries	
	Number	Assets
Arizona	1	\$76.0
California	21	47,873.5
Delaware	1	519.7
District of Columbia	2	109.8
Florida	2	346.6
Illinois	21	22,812.9
Maryland	1	6,843.9
New Jersey	1	6,651.9
New Mexico	2	327.0
New York	32	75,480.3
Rhode Island	1	799.6
Total	85	\$161,841.1

Note 1: A foreign-owned bank subsidiary is any organization that has 25 percent or more of its voting shares directly or indirectly owned, controlled, or held with power to vote by a foreign banking organization or by any organization that is otherwise controlled or capable of being controlled by a foreign banking organization.

Note 2: Data are for the period ending December 31, 1992.

Source: Federal Reserve and call report data.

Changes in Banking Company Structure

In this appendix, we present in tables detailed information that was summarized in the chapters of this report. Table II.1 shows states by their interstate banking and in-state branching laws. Tables II.2 and II.3 present the following information on banking companies in each state: the number of banking companies, the percentage of state banking assets controlled by banking companies headquartered outside of a state, and the concentration ratio of the three largest banking companies by state. Table II.2 presents the information in alphabetical order, while table II.3 presents the same information sorted by the percentage of national banking assets held in the state.

Table II.4 shows interstate banking laws and categorizes the percentage of out-of-state ownership in each state by law. Table II.5 presents this information in detail for each state. Tables II.6 and II.7 compare states by their percentage of out-of-state ownership of state banking assets and concentration ratios of the three largest banking companies.

Tables II.8 through II.10 present information on changes in the market share of community banks in each state. Table II.8 categorizes changes in the market share of community banks and compares this information with the percentage of out-of-state ownership by state. Table II.9 presents more detailed information by state and the general direction of changes in the market share of community banks. Table II.10 presents the actual percentage changes in the market share of community banks.

Table II.11 shows the correlation between the employment growth rate in each state and the percentage of out-of-state ownership.

Appendix II
Changes in Banking Company Structure

**Table II.1: Interstate Banking and
 In-State Branching Laws by State as of
 December 31, 1992**

Interstate banking laws	In-state branching laws	
	Statewide	Limited
National	Alaska Arizona District of Columbia Idaho Maine Nevada New Hampshire New Mexico Oregon Texas Utah	Colorado Oklahoma Wyoming
National reciprocal	California Connecticut Delaware Louisiana Massachusetts Michigan New Jersey New York Ohio Pennsylvania Rhode Island South Dakota Tennessee Vermont Washington West Virginia	Illinois Indiana Kentucky Nebraska North Dakota
Regional reciprocal	Alabama Florida Kansas Maryland Mississippi Missouri North Carolina South Carolina Virginia Wisconsin	Arkansas Georgia Iowa Minnesota
No interstate banking	Hawaii	Montana ^a

^aMontana enacted a regional reciprocal law that took effect October 1, 1993.

Source: Federal Reserve and Conference of State Bank Supervisors data.

**Appendix II
Changes in Banking Company Structure**

Table II.2: Banking Company Information by State

State	Interstate banking law	In-state branching law	Percentage of assets held by out-of-state banking companies	Concentration ratio of the three largest banking companies	Percentage of national banking assets held in state	Number of banking companies	Number of five largest banking companies headquartered out of state
Alabama	RR	S	2.4%	55.0%	1.3%	177	0
Alaska	N	S	21.0	88.2	0.1	8	2
Arizona	N	S	64.8	82.6	1.0	36	3
Arkansas	RR	L	2.1	25.6	0.7	190	0
California	NR	S	15.4	62.3	9.5	434	2
Colorado	N	L	43.9	38.2	0.9	217	4
Connecticut	NR	S	39.3	68.9	0.9	47	4
Delaware	NR	S	68.8	34.5	2.2	37	3
District of Columbia	N	S	52.9	70.6	0.4	22	3
Florida	RR	S	51.6	59.8	4.2	318	4
Georgia	RR	L	41.7	48.1	2.2	310	3
Hawaii	N/A	S	5.6	86.3	0.6	16	1
Idaho	N	S	55.0	78.2	0.3	18	4
Illinois	NR	L	21.7	37.3	5.8	714	2
Indiana	NR	L	52.9	41.3	1.7	181	4
Iowa	RR	L	25.9	26.6	1.1	418	3
Kansas	RR	S	0.1	22.0	0.9	448	0
Kentucky	NR	L	40.4	38.2	1.3	236	3
Louisiana	NR	S	5.2	37.8	1.1	211	2
Maine	N	S	79.9	76.8	0.3	22	4
Maryland	RR	S	39.3	44.9	1.5	78	3
Massachusetts	NR	S	23.2	59.0	2.7	59	0
Michigan	NR	S	3.2	58.8	2.9	142	0
Minnesota	RR	L	2.9	56.7	1.7	472	1
Mississippi	RR	S	2.1	42.2	0.7	120	0
Missouri	RR	S	1.9	46.7	1.9	362	0
Montana ^a	N/A	L	31.8	37.8	0.2	94	2
Nebraska	NR	L	10.2	37.4	0.7	313	1
Nevada	N	S	93.4	84.2	0.4	17	5
New Hampshire	N	S	27.6	59.1	0.2	26	1
New Jersey	NR	S	17.1	42.7	2.9	96	2
New Mexico	N	S	36.7	51.9	0.4	56	2
New York	NR	S	13.2	51.2	20.1	161	0

(continued)

**Appendix II
Changes in Banking Company Structure**

State	Interstate banking law	In-state branching law	Percentage of assets held by out-of-state banking companies	Concentration ratio of the three largest banking companies	Percentage of national banking assets held in state	Number of banking companies	Number of five largest banking companies headquartered out of state
North Carolina	RR	S	0.2	65.5	2.5	72	0
North Dakota	NR	L	31.5	31.5	0.2	122	3
Ohio	NR	S	4.0	47.6	3.6	213	0
Oklahoma	N	L	11.8	21.4	0.8	362	2
Oregon	N	S	44.6	78.2	0.7	45	3
Pennsylvania	NR	S	10.2	47.0	5.3	219	0
Rhode Island	NR	S	31.2	90.9	0.4	12	2
South Carolina	RR	S	69.4	63.4	0.8	77	3
South Dakota	NR	S	65.4	61.5	0.5	99	3
Tennessee	NR	S	29.3	39.6	1.5	203	2
Texas	N	S	49.4	41.5	5.0	942	4
Utah	N	S	24.8	60.5	0.4	53	3
Vermont	NR	S	4.4	65.0	0.2	17	1
Virginia	RR	S	21.0	44.0	2.1	139	1
Washington	NR	S	74.2	62.4	1.2	88	4
West Virginia	NR	S	4.7	37.5	0.6	91	0
Wisconsin	RR	S	18.2	42.6	1.5	296	1
Wyoming	N	L	42.0	39.7	0.1	51	3

Legend

N = Nationwide banking, no restrictions
 NR = Nationwide reciprocal banking
 RR = Regional reciprocal banking
 N/A = No interstate banking allowed
 S = Statewide branching permitted
 L = Limited area branching only

Note: Data are for the period ending December 31, 1992.

*Montana enacted regional reciprocal legislation that took effect October 1, 1993.

Source: Call report data.

Appendix II
Changes in Banking Company Structure

Table II.3: Banking Company Information, Ranked by Each State's Percentage of National Banking Assets

By state	Interstate banking law	In-state branching law
Larger banking presence		
New York	NR	S
California	NR	S
Illinois	NR	L
Pennsylvania	NR	S
Texas	N	S
Florida	RR	S
Ohio	NR	S
New Jersey	NR	S
Michigan	NR	S
Massachusetts	NR	S
North Carolina	RR	S
Delaware	NR	S
Georgia	RR	L
Virginia	RR	S
Medium banking presence		
Missouri	RR	S
Minnesota	RR	L
Indiana	NR	L
Maryland	RR	S
Wisconsin	RR	S
Tennessee	NR	S
Alabama	RR	S
Kentucky	NR	L
Washington	NR	S
Louisiana	NR	S
Iowa	RR	L
Arizona	N	S
Smaller banking presence		
Connecticut	NR	S
Colorado	N	L
Kansas	RR	S
Oklahoma	N	L
South Carolina	RR	S
Nebraska	NR	L
Oregon	N	S

**Appendix II
Changes in Banking Company Structure**

Percentage of assets held by out-of-state banking companies	Concentration ratio of the three largest banking companies	Percentage of national banking assets held in state	Number of banking companies	Number of five largest banking companies headquartered out of state
13.2%	51.2%	20.1%	161	0
15.4	62.3	9.5	434	2
21.7	37.3	5.8	714	2
10.2	47.0	5.3	219	0
49.4	41.5	5.0	942	4
51.6	59.8	4.2	318	4
4.0	47.6	3.6	213	0
17.1	42.7	2.9	96	2
3.2	58.8	2.9	142	0
23.2	59.0	2.7	59	0
0.2	65.5	2.5	72	0
68.8	34.5	2.2	37	3
41.7	48.1	2.2	310	3
21.0	44.0	2.1	139	1
1.9%	46.7%	1.9%	362	0
2.9	56.7	1.7	472	1
52.9	41.3	1.7	181	4
39.3	44.9	1.5	78	3
18.2	42.6	1.5	296	1
29.3	39.6	1.5	203	2
2.4	55.0	1.3	177	0
40.4	38.2	1.3	236	3
74.2	62.4	1.2	88	4
5.2	37.8	1.1	211	2
25.9	26.6	1.1	418	3
64.8	82.6	1.0	36	3
39.3%	68.9%	0.9%	47	4
43.9	38.2	0.9	217	4
0.1	22.0	0.9	448	0
11.8	21.4	0.8	362	2
69.4	63.4	0.8	77	3
10.2	37.4	0.7	313	1
44.6	78.2	0.7	45	3

(continued)

Appendix II
Changes in Banking Company Structure

By state	Interstate banking law	In-state branching law
Arkansas	RR	L
Mississippi	RR	S
Hawaii	N/A	S
West Virginia	NR	S
South Dakota	NR	S
Utah	N	S
District of Columbia	N	S
Nevada	N	S
Rhode Island	NR	S
New Mexico	N	S
Idaho	N	S
Maine	N	S
Montana ^a	N/A	L
New Hampshire	N	S
North Dakota	NR	L
Vermont	NR	S
Wyoming	N	L
Alaska	N	S

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Changes in Banking Company Structure**

Percentage of assets held by out-of-state banking companies	Concentration ratio of the three largest banking companies	Percentage of national banking assets held in state	Number of banking companies	Number of five largest banking companies headquartered out of state
2.1	25.6	0.7	190	0
2.1	42.2	0.7	120	0
5.6	86.3	0.6	16	1
4.7	37.5	0.6	91	0
65.4	61.5	0.5	99	3
24.8	60.5	0.4	53	3
52.9	70.6	0.4	22	3
93.4	84.2	0.4	17	5
31.2	90.9	0.4	12	2
36.7	51.9	0.4	56	2
55.0	78.2	0.3	18	4
79.9	76.8	0.3	22	4
31.8	37.8	0.2	94	2
27.6	59.1	0.2	26	1
31.5	31.5	0.2	122	3
4.4	65.0	0.2	17	1
42.0	39.7	0.1	51	3
21.0	88.2	0.1	8	2

Legend

- N = Nationwide banking, no restrictions
- NR = Nationwide reciprocal banking
- RR = Regional reciprocal banking
- N/A = No interstate banking allowed
- S = Statewide branching permitted
- L = Limited area branching only

Note 1: Banking presence is determined by the percentage of national banking assets held in the state. We designated as a larger banking presence those states that had 2 percent or more of national banking assets; medium, as those with 1 to 2 percent; and smaller, as those with less than 1 percent.

Note 2: Data are for the period ending December 31, 1992.

*Montana enacted regional reciprocal legislation that took effect October 1, 1993.

Source: Call report data.

**Appendix II
Changes in Banking Company Structure**

Table II.4: States Categorized by Their Percentage of Out-of-State Ownership and State Interstate Banking Laws as of December 31, 1992

Interstate banking laws	States with out-of-state ownership of		
	40% or more	Less than 40% but more than 10%	10% or less
Nationwide	Arizona Colorado District of Columbia Idaho Maine Nevada Oregon Texas Wyoming	Alaska New Hampshire New Mexico Oklahoma Utah	
Nationwide reciprocal	Delaware Indiana Kentucky South Dakota Washington	California Connecticut Illinois Massachusetts Nebraska New Jersey New York North Dakota Pennsylvania Rhode Island Tennessee	Louisiana Michigan Ohio Vermont West Virginia
Regional reciprocal	Florida Georgia South Carolina	Iowa Maryland Virginia Wisconsin	Alabama Arkansas Kansas Minnesota Mississippi Missouri North Carolina
No interstate banking		Montana ^a	Hawaii

^aMontana enacted a regional reciprocal law that took effect October 1, 1993.

Source: Federal Reserve and Conference of State Bank Supervisors data.

**Appendix II
Changes in Banking Company Structure**

Table II.5: Banking Company Information by Interstate Banking Laws

By state	In-state branching law	Percentage of assets held by out-of-state banking companies	Percentage of national banking assets held in state	Number of banking companies
Nationwide				
Nevada	S	93.4%	0.4%	17
Maine	S	79.9	0.3	22
Arizona	S	64.8	1.0	36
Idaho	S	55.0	0.3	18
District of Columbia	S	52.9	0.4	22
Texas	S	49.4	5.0	942
Oregon	S	44.6	0.7	45
Colorado	L	43.9	0.9	217
Wyoming	L	42.0	0.1	51
New Mexico	S	36.7	0.4	56
New Hampshire	S	27.6	0.2	26
Utah	S	24.8	0.4	53
Alaska	S	21.0	0.1	8
Oklahoma	L	11.8	0.8	362
Nationwide reciprocal				
Washington	S	74.2%	1.2%	88
Delaware	S	68.8	2.2	37
South Dakota	S	65.4	0.5	99
Indiana	L	52.9	1.7	181
Kentucky	L	40.4	1.3	236
Connecticut	S	39.3	0.9	47
North Dakota	L	31.5	0.2	122
Rhode Island	S	31.2	0.4	12
Tennessee	S	29.3	1.5	203
Massachusetts	S	23.2	2.7	59
Illinois	L	21.7	5.8	714
New Jersey	S	17.1	2.9	96
California	S	15.4	9.5	434
New York	S	13.2	20.1	161
Nebraska	L	10.2	0.7	313
Pennsylvania	S	10.2	5.3	219
Louisiana	S	5.2	1.1	211
West Virginia	S	4.7	0.6	91

(continued)

**Appendix II
Changes in Banking Company Structure**

By state	In-state branching law	Percentage of assets held by out-of-state banking companies	Percentage of national banking assets held in state	Number of banking companies
Vermont	S	4.4	0.2	17
Ohio	S	4.0	3.6	213
Michigan	S	3.2	2.9	142
Regional reciprocal				
South Carolina	S	69.4%	0.8%	77
Florida	S	51.6	4.2	318
Georgia	L	41.7	2.2	310
Maryland	S	39.3	1.5	78
Iowa	L	25.9	1.1	418
Virginia	S	21.0	2.1	139
Wisconsin	S	18.2	1.5	296
Minnesota	L	2.9	1.7	472
Alabama	S	2.4	1.3	177
Arkansas	L	2.1	0.7	190
Mississippi	S	2.1	0.7	120
Missouri	S	1.9	1.9	362
North Carolina	S	0.2	2.5	72
Kansas	S	0.1	0.9	448
No interstate banking allowed				
Montana ^a	L	31.8%	0.2%	94
Hawaii	S	5.6	0.6	16

Legend

S = Statewide branching allowed
L = Limited area branching only

Note: Data are for the period ending December 31, 1992.

^aMontana enacted regional reciprocal legislation that took effect October 1, 1993.

Source: Call report data.

Appendix II
Changes in Banking Company Structure

Table II.6: Changes in Concentration Levels of Each State's Three Largest Banking Companies Compared to the Percentage of Out-of-State Ownership of Each State's Banking Assets

Percentage of out-of-state ownership for 1992	States where the change in the concentration ratio of the three largest banking companies		
	Falls	Rises by less than 20 percent	Rises by 20 percent or more
High (40% or more)	Colorado District of Columbia Georgia Oregon South Carolina South Dakota Washington Wyoming	Arizona Delaware Idaho Kentucky Nevada	Florida Indiana Maine Texas
Medium (less than 40% but more than 10%)	Illinois Montana New Jersey North Dakota Oklahoma Pennsylvania Tennessee Utah Virginia	California Connecticut Maryland Massachusetts New Hampshire New Mexico New York Rhode Island Wisconsin	Alaska Iowa Nebraska
Low (10% or less)	Minnesota North Carolina	Alabama Arkansas Hawaii Louisiana Mississippi Missouri Ohio	Kansas Michigan Vermont West Virginia

Note: Changes in concentration ratios are for the period December 31, 1986, to December 31, 1992.

Source: Call report data.

Appendix II
Changes in Banking Company Structure

**Table II.7: State Banking Information
Ranked by the Percentage Change in
the Concentration Ratio of the Three
Largest Banking Companies From
1986-92**

State	Concentration ratio for the three largest banking companies			Percentage of state banking assets controlled by out-of-state banking companies	
	1986	1992	Percentage change	1986	1992
Alaska	54.6%	88.2%	61.5%	14.9%	21.0%
West Virginia	24.0	37.5	56.3	0.0	4.7
Indiana	27.2	41.3	51.8	13.1	52.9
Florida	43.0	59.8	39.1	33.4	51.6
Kansas	16.3	22.0	35.0	0.0	0.1
Nebraska	28.1	37.4	33.1	9.5	10.2
Maine	57.8	76.8	32.9	86.2	79.9
Vermont	49.1	65.0	32.4	0.0	4.4
Iowa	20.6	26.6	29.1	8.1	25.9
Texas	34.4	41.5	20.6	0.0	49.4
Michigan	49.0	58.8	20.0	0.6	3.2
Ohio	39.8	47.6	19.6	0.7	4.0
Missouri	39.3	46.7	18.8	0.0	1.9
Arkansas	22.0	25.6	16.4	0.0	2.1
Mississippi	37.2	42.2	13.4	0.0	2.1
New Hampshire	52.1	59.1	13.4	0.1	27.6
Massachusetts	52.9	59.0	11.5	2.7	23.2
Louisiana	34.3	37.8	10.2	0.0	5.2
New York	47.4	51.2	8.0	12.0	13.2
Arizona	77.2	82.6	7.0	46.6	64.8
Hawaii	80.8	86.3	6.8	5.4	5.6
Wisconsin	40.0	42.6	6.5	3.6	18.2
Kentucky	36.1	38.2	5.8	4.7	40.4
Connecticut	65.3	68.9	5.5	42.2	39.3
Nevada	80.2	84.2	5.0	66.1	93.4
New Mexico	49.5	51.9	4.8	14.0	36.7
Delaware	33.0	34.5	4.5	66.1	68.8
Idaho	75.4	78.2	3.7	36.8	55.0
Maryland	43.3	44.9	3.7	37.3	39.3
Alabama	53.1	55.0	3.6	0.0	2.4
Rhode Island	87.9	90.9	3.4	32.3	31.2
California	61.3	62.3	1.6	13.0	15.4
Utah	61.0	60.5	-0.8	14.1	24.8

(continued)

Appendix II
Changes in Banking Company Structure

State	Concentration ratio for the three largest banking companies			Percentage of state banking assets controlled by out-of-state banking companies	
	1986	1992	Percentage change	1986	1992
District of Columbia	71.8	70.6	-1.7	22.0	52.9
South Carolina	64.9	63.4	-2.3	46.4	69.4
Wyoming	40.8	39.7	-2.7	12.3	42.0
Pennsylvania	48.5	47.0	-3.1	0.0	10.2
Oregon	81.4	78.2	-3.9	37.9	44.6
Washington	65.5	62.4	-4.7	40.7	74.2
Colorado	41.1	38.2	-7.1	11.8	43.9
North Carolina	70.8	65.5	-7.5	0.4	0.2
Tennessee	43.0	39.6	-7.9	16.2	29.3
Virginia	48.1	44.0	-8.5	6.5	21.0
Georgia	52.9	48.1	-9.1	24.3	41.7
Minnesota	63.1	56.7	-10.1	0.0	2.9
New Jersey	48.2	42.7	-11.4	3.3	17.1
North Dakota	35.7	31.5	-11.8	35.7	31.5
South Dakota	72.3	61.5	-14.9	75.8	65.4
Montana ^a	45.1	37.8	-16.2	40.7	31.8
Oklahoma	26.6	21.4	-19.5	4.8	11.8
Illinois	48.8	37.3	-23.6	8.3	21.7

Note: Data are for the periods ending December 31, 1986, and December 31, 1992.

^aMontana enacted regional reciprocal legislation that took effect October 1, 1993.

Source: Call report data.

Appendix II
Changes in Banking Company Structure

Table II.8: Changes in Community Bank Market Share and Out-of-State Ownership of State Banking Assets

Percentage of out-of-state ownership for 1992	States where the community bank market share is		
	Falling	Rising	Mixed
High (40% or more)	Arizona Delaware Idaho Indiana Kentucky	Colorado District of Columbia Florida Georgia Maine Nevada South Carolina South Dakota Texas Washington	Oregon Wyoming
Medium (less than 40% but more than 10%)	Alaska Illinois Iowa Nebraska Pennsylvania Tennessee Wisconsin	California Connecticut Maryland Massachusetts Montana New Hampshire New Mexico New York North Dakota Rhode Island Utah Virginia	New Jersey Oklahoma
Low (10% or less)	Alabama Arkansas Hawaii Kansas Michigan Mississippi Missouri Ohio West Virginia	Minnesota North Carolina	Louisiana Vermont

Note 1: The following four size classes were used to define community banks: \$1 billion or less in assets, \$500 million or less, \$300 million or less, and \$100 million or less. If at least three of the four size classes in a state showed increased market share, the community bank market share was classified as rising. If at least three of four fell, the market share was classified as falling. If two rose and two fell, the market share was mixed.

Note 2: Changes in market share are for the period December 31, 1986, to December 31, 1992.

Source: Call report data.

Appendix II
Changes in Banking Company Structure

**Appendix II
Changes in Banking Company Structure**

Table II.9: Direction of Changes in Market Share of Community Banking Companies by State

By state	Interstate banking law	In-state branching law
High out-of-state ownership		
Nevada	N	S
Maine	N	S
Washington	NR	S
South Carolina	RR	S
Delaware	NR	S
South Dakota	NR	S
Arizona	N	S
Idaho	N	S
District of Columbia	N	S
Indiana	NR	L
Florida	RR	S
Texas	N	S
Oregon	N	S
Colorado	N	L
Wyoming	N	L
Georgia	RR	L
Kentucky	NR	L
Medium out-of-state ownership		
Connecticut	NR	S
Maryland	RR	S
New Mexico	N	S
Montana ^b	N/A	L
North Dakota	NR	L
Rhode Island	NR	S
Tennessee	NR	S
New Hampshire	N	S
Iowa	RR	L
Utah	N	S
Massachusetts	NR	S
Illinois	NR	L
Virginia	RR	S
Alaska	N	S
Wisconsin	RR	S
New Jersey	NR	S
California	NR	S

**Appendix II
Changes in Banking Company Structure**

Percentage of assets held by out-of-state banking companies	Concentration ratio of the three largest banking companies	Changes in the market share of community banking companies			
		Less than \$100 million	Less than \$300 million	Less than \$500 million	Less than \$1 billion
93.4%	84.2%	X	X	X	
79.9	76.8	X	X	X	X
74.2	62.4	X	X	X	X
69.4	63.4	X	X		X
68.8	34.5				
65.4	61.5	X	X	X	X
64.8	82.6				X
55.0	78.2				
52.9	70.6	X	X	X	X
52.9	41.3				
51.6	59.8	X	X	X	X
49.4	41.5	X	X	X	X
44.6	78.2		X		X
43.9	38.2		X	X	X
42.0	39.7	X		X	
41.7	48.1	X	X	X	X
40.4	38.2				
39.3%	68.9%	X	X	X	X
39.3	44.9	X	X		X
36.7	51.9		X	X	X
31.8	37.8	X	X	X	X
31.5	31.5	X		X	X
31.2	90.9		X	X	X
29.3	39.6				
27.6	59.1		X	X	X
25.9	26.6			a	
24.8	60.5	X	X		X
23.2	59.0	X	X		X
21.7	37.3				
21.0	44.0		X	X	X
21.0	88.2	X			
18.2	42.6				
17.1	42.7	X	X		
15.4	62.3	X	X	X	X

(continued)

Appendix II
Changes in Banking Company Structure

By state	Interstate banking law	In-state branching law
New York	NR	S
Oklahoma	N	L
Nebraska	NR	L
Pennsylvania	NR	S
Low out-of-state ownership		
Hawaii	N/A	S
Louisiana	NR	S
West Virginia	NR	S
Vermont	NR	S
Ohio	NR	S
Michigan	NR	S
Minnesota	RR	L
Alabama	RR	S
Arkansas	RR	L
Mississippi	RR	S
Missouri	RR	S
North Carolina	RR	S
Kansas	RR	S

**Appendix II
Changes in Banking Company Structure**

Percentage of assets held by out-of-state banking companies	Concentration ratio of the three largest banking companies	Changes in the market share of community banking companies			
		Less than \$100 million	Less than \$300 million	Less than \$500 million	Less than \$1 billion
13.2	51.2	X	X	X	X
11.8	21.4			X	X
10.2	37.4				
10.2	47.0				X
5.6%	86.3%				
5.2	37.8		X	X	
4.7	37.5				
4.4	65.0	X	X		
4.0	47.6				
3.2	58.8				X
2.9	56.7		X	X	X
2.4	55.0			X	
2.1	25.6				
2.1	42.2				
1.9	46.7				X
0.2	65.5	X	X	X	X
0.1	22.0				

Legend

N = Nationwide banking, no restrictions
 N/A = No interstate banking allowed
 NR = Nationwide reciprocal banking
 RR = Regional reciprocal banking
 S = Statewide branching permitted
 L = Limited area branching only
 X = Indicates an increase in market share

Note 1: Out-of-state ownership is divided into three categories. High represents an ownership of 40 percent or more; medium, less than 40 percent but more than 10 percent; and low, 10 percent or less.

Note 2: An empty cell indicates a decrease in market share.

Note 3: Data are for the periods ending December 31, 1986, and December 31, 1992.

^aIndicates neither an increase or decrease in market share.

^bMontana enacted regional reciprocal legislation that took effect on October 1, 1993.

Source: Call report data.

Appendix II
Changes in Banking Company Structure

Table II.10: Percentage Changes in Market Share of Community Banking Companies by State

	By state	Interstate banking law	In-state branching law
High out-of-state ownership			
	Nevada	N	S
	Maine	N	S
	Washington	NR	S
	South Carolina	RR	S
	Delaware	NR	S
	South Dakota	NR	S
	Arizona	N	S
	Idaho	N	S
	District of Columbia	N	S
	Indiana	NR	L
	Florida	RR	S
	Texas	N	S
	Oregon	N	S
	Colorado	N	L
	Wyoming	N	L
	Georgia	RR	L
	Kentucky	NR	L
Medium out-of-state ownership			
	Connecticut	NR	S
	Maryland	RR	S
	New Mexico	N	S
	Montana ^a	N/A	L
	North Dakota	NR	L
	Rhode Island	NR	S
	Tennessee	NR	S
	New Hampshire	N	S
	Iowa	RR	L
	Utah	N	S
	Massachusetts	NR	S
	Illinois	NR	L
	Virginia	RR	S
	Alaska	N	S
	Wisconsin	RR	S
	New Jersey	NR	S
	California	NR	S

**Appendix II
Changes in Banking Company Structure**

Percentage of assets held by out-of-state companies	Concentration ratio of the three largest banking companies	Changes in the market share of community banks			
		Less than \$100 million	Less than \$300 million	Less than \$500 million	Less than \$1 billion
93.4%	84.2%	16.6%	47.6%	31.7%	-20.5%
79.9	76.8	86.2	22.7	47.3	47.3
74.2	62.4	24.3	18.3	27.5	8.1
69.4	63.4	4.4	3.9	-0.7	30.5
68.8	34.5	-13.4	-60.0	-64.4	-65.8
65.4	61.5	20.1	49.4	59.2	56.6
64.8	82.6	-42.1	-27.3	-13.2	4.5
55.0	78.2	-29.0	-35.6	-22.7	-11.3
52.9	70.6	44.6	128.6	53.3	63.1
52.9	41.3	-36.5	-34.1	-23.7	-24.0
51.6	59.8	10.3	2.1	9.2	8.3
49.4	41.5	6.8	23.8	32.6	24.3
44.6	78.2	-31.8	0.5	-22.8	10.7
43.9	38.2	-10.4	8.7	17.0	14.3
42.0	39.7	0.6	-18.9	27.4	-6.3
41.7	48.1	10.2	5.3	10.1	5.5
40.4	38.2	-18.0	-17.3	-22.9	-10.8
39.3%	68.9%	42.5%	45.0%	5.0%	6.7%
39.3	44.9	7.2	0.5	-7.1	17.7
36.7	51.9	-30.7	2.5	2.3	19.3
31.8	37.8	9.6	33.4	13.5	30.6
31.5	31.5	2.8	-2.6	6.7	22.6
31.2	90.9	-0.4	2.0	14.3	25.1
29.3	39.6	-13.6	-9.0	-4.7	-11.4
27.6	59.1	-55.2	18.7	4.1	12.9
25.9	26.6	-13.5	-12.3	0.0	-1.8
24.8	60.5	3.8	13.2	-4.4	66.6
23.2	59.0	39.8	20.2	-5.5	10.1
21.7	37.3	-21.0	-18.6	-16.5	-8.5
21.0	44.0	-7.5	5.4	17.7	17.6
21.0	88.2	55.6	-3.8	-51.7	-53.4
18.2	42.6	-13.0	-11.0	-8.1	-13.4
17.1	42.7	25.4	6.5	-0.2	-4.4
15.4	62.3	7.9	11.3	16.4	28.7

(continued)

Appendix II
Changes in Banking Company Structure

By state	Interstate banking law	In-state branching law
New York	NR	S
Oklahoma	N	L
Nebraska	NR	L
Pennsylvania	NR	S
Low out-of-state ownership		
Hawaii	N/A	S
Louisiana	NR	S
West Virginia	NR	S
Vermont	NR	S
Ohio	NR	S
Michigan	NR	S
Minnesota	RR	L
Alabama	RR	S
Arkansas	RR	L
Mississippi	RR	S
Missouri	RR	S
North Carolina	RR	S
Kansas	RR	S

**Appendix II
Changes in Banking Company Structure**

Percentage of assets held by out-of-state companies	Concentration ratio of the three largest banking companies	Changes in the market share of community banks			
		Less than \$100 million	Less than \$300 million	Less than \$500 million	Less than \$1 billion
13.2	51.2	6.2	29.4	58.1	47.3
11.8	21.4	-0.7	-0.7	1.3	2.4
10.2	37.4	-23.5	-25.2	-16.0	-16.0
10.2	47.0	-22.8	-2.8	-3.6	5.7
5.6%	86.3%	-25.3%	-74.6%	-56.4%	-44.5%
5.2	37.8	-5.6	0.9	3.3	-4.7
4.7	37.5	-43.4	-45.2	-51.2	-22.9
4.4	65.0	31.1	9.9	-14.2	-35.2
4.0	47.6	-16.1	-16.2	-13.5	-9.8
3.2	58.8	-22.4	-13.9	-19.6	2.6
2.9	56.7	-0.7	10.7	17.9	18.3
2.4	55.0	-21.7	-0.8	5.1	-3.1
2.1	25.6	-16.6	-11.3	-4.7	-8.0
2.1	42.2	-14.0	-19.4	-12.7	-11.3
1.9	46.7	-1.0	-4.2	-8.0	6.5
0.2	65.5	25.8	22.9	19.4	19.4
0.1	22.0	-17.8	-14.2	-10.3	-5.8

Legend

N = Nationwide, no restrictions
 N/A = No interstate banking allowed
 RR = Regional reciprocal banking
 S = Statewide branching permitted
 L = Limited area branching only

Note 1: Out-of-state ownership is divided into three categories. High represents an ownership of 40 percent or more; medium, less than 40 percent but more than 10 percent; and low, 10 percent or less.

Note 2: Data are for the periods ending December 31, 1986, and December 31, 1992.

*Montana enacted regional reciprocal legislation that took effect on October 1, 1993.

Source: Call report data.

**Appendix II
Changes in Banking Company Structure**

Table II.11: Changes in State Employment Rates Between 1986 and 1991 and Out-of-State Ownership of State Banking Assets

Percentage of out-of-state ownership for 1992	States with employment growth rates of				
	Less than 0%	0 to 4.9%	5 to 6.9%	7 to 9.9%	10% or more
High (40% or more)	District of Columbia	Connecticut Wyoming	Maryland South Dakota	Arizona South Carolina Texas	Delaware Florida Idaho Maine Nevada Oregon Washington
Medium (less than 40% but more than 10%)	Massachusetts North Dakota Rhode Island	Alaska Indiana Montana New Jersey New York	Colorado Georgia Kentucky Pennsylvania Tennessee	California Illinois Iowa New Hampshire New Mexico Utah	Virginia Wisconsin
Low (10% or less)	Oklahoma	Alabama Louisiana Michigan Vermont	Arkansas Kansas Mississippi Missouri Ohio	Nebraska North Carolina West Virginia	Hawaii Minnesota

Source: Call report and Department of Labor data.

Supervision and Regulation of a Multistate Bank Holding Company

The U.S. regulatory and supervisory system is a complex dual structure in which federal and state authorities share responsibility for supervising banks and bank holding companies. The system consists of three relatively autonomous federal regulatory agencies—the Federal Reserve, OCC, and FDIC—and 50 state banking departments. To demonstrate the complexity of the U.S. banking and regulatory system, we created a hypothetical bank holding company with a number of bank and nonbank subsidiaries. Figure III.1 illustrates the structure of this company and identifies its points of contact with the various bank regulators.

Supervision of Bank Holding Companies and Their Subsidiaries

The supervision of bank holding companies and their subsidiaries is either shared among the three federal regulatory agencies and the 50 state banking departments or carried out by a single federal regulatory agency. The Federal Reserve supervises all bank holding companies and all nonbank subsidiaries and shares the supervision of state member banks with the state banking departments. OCC only supervises national banks. FDIC shares the supervision of state nonmember banks with the state banking departments. As we show in figure III.1, our hypothetical bank holding company must deal with all three federal bank regulators and perhaps as many as three state banking departments. In the following sections, we briefly discuss each component of our hypothetical multistate bank holding company and its regulation.

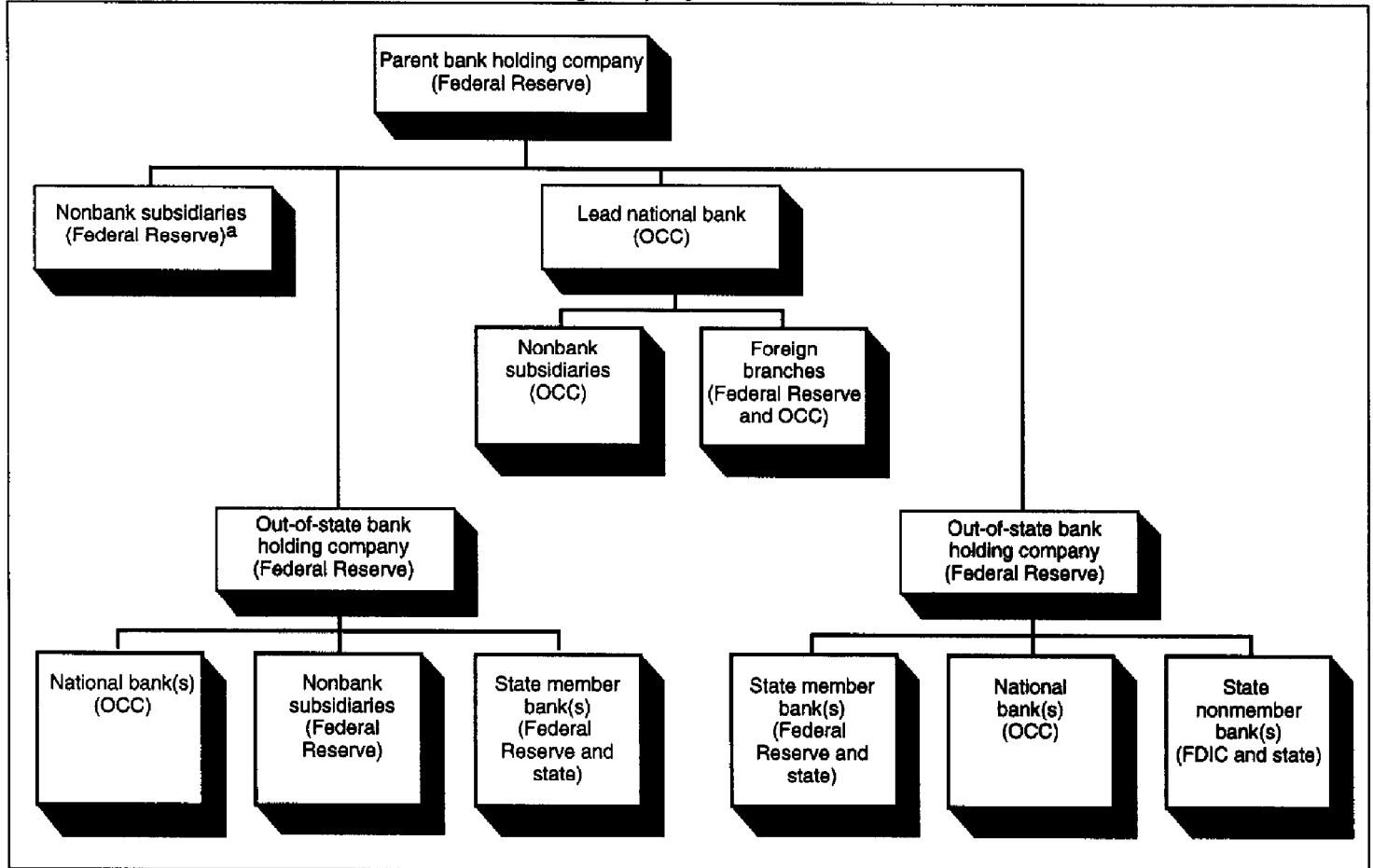
Supervision of a Bank Holding Company

The Federal Reserve supervises the parent bank holding company and all lower tier bank holding companies.¹ In our example, the Federal Reserve would supervise the parent bank holding company and the two lower tier bank holding companies. To ensure that a bank holding company is operating in a safe and sound manner, the Federal Reserve inspects the bank holding company. A Federal Reserve inspection focuses on the holding company's policies concerning the supervision of subsidiaries, the financial analysis of the parent and consolidated companies, and a review and classification of the assets of the credit-extending nonbank subsidiaries. Central to the inspection process is the evaluation of the holding company's organizational policies, the adequacy of its loan review, the risk assessment process, and the auditing function.

¹The Federal Reserve is composed of a board of governors and 12 district Federal Reserve Banks located in Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco.

**Appendix III
Supervision and Regulation of a Multistate
Bank Holding Company**

Figure III.1: Regulation of a Hypothetical Bank Holding Company



Note: State and federal regulators for each bank are in parentheses.

^aNonbank subsidiaries may also be regulated by other federal and state regulators.

The frequency of bank holding company inspections is determined by the size, financial condition, and complexity of the institution. The Federal Reserve defines a complex bank holding company as one with credit-extending nonbank subsidiaries or debt outstanding to the general public. All complex bank holding companies, except those with less than \$150 million in assets, must be annually inspected by the Federal Reserve. Bank holding companies with no credit-extending nonbank subsidiaries or no publicly held debt are required to be inspected every 2 or 3 years, depending on their asset size and financial condition.

The planning and scheduling of inspections for smaller bank holding companies are handled by the individual Federal Reserve Banks. For larger bank holding companies, the planning and scheduling of inspections are handled by the staff of the Federal Reserve's Board of Governors in Washington, D.C.

The day-to-day supervision of bank holding companies is carried out by the individual Federal Reserve Banks. The Federal Reserve Bank responsible for the supervision of the parent bank holding company, known as the responsible Reserve Bank, is also responsible for the supervision of all lower tier bank holding companies and their nonbank operations, regardless of the district in which these operations are located.

Supervision of State Member Banks

Our hypothetical bank holding company has two state member banks. These two state member banks are regulated by both the Federal Reserve and the banking department of the states in which they are located. The Federal Reserve requires an annual full-scope examination for all state member banks.² The examination focuses on five critical areas of bank operations and condition—capital adequacy, asset quality, management, earnings, and liquidity—commonly referred to by the acronym CAMEL. Each area is rated, using a 5-point scale, with 1 as the best and 5 as the worst, and the bank receives an overall rating. Bank examinations are conducted by the Federal Reserve Banks and the state banking departments. The Federal Reserve Bank responsible for a multistate parent bank holding company relies as much as possible on other Federal Reserve Banks to examine the bank subsidiaries located in each of their districts.

Although state member banks must be examined annually, the Federal Reserve may alternate its examination of highly rated state member banks with a state examination. In 1981, the Federal Reserve instituted its Alternate Examination programs with state banking departments. Under the Alternate Examination programs, those state member banks that are relatively free of problems are examined in alternate years by the Federal Reserve Bank and the state banking department. As of September 10, 1992,

²The Federal Deposit Insurance Corporation Improvement Act requires at least an annual full-scope, on-site safety and soundness examination of all insured institutions.

**Appendix III
Supervision and Regulation of a Multistate
Bank Holding Company**

36 states have participated in some form of the program, including joint or concurrent examinations.³

On September 9, 1992, the Federal Reserve entered into a joint resolution with the Conference of State Bank Supervisors.⁴ The resolution provides a framework for each Federal Reserve Bank to enter into examination agreements with the individual state banking departments in their districts. The agreements between the Federal Reserve Banks and the state banking departments specify eligible banks, asset size limitations, CAMEL rating criteria, and minimum examination procedures for permitting examinations on an alternate-year basis.

**Supervision of National
Banks**

Our hypothetical bank holding company has three national banks. National banks are chartered by OCC and are members of the Federal Reserve. OCC has primary responsibility for the supervision of national banks. Most of OCC's supervisory work is done at its six district offices.⁵ Eight of the largest national banks, however, are supervised by OCC's multinational division in Washington, D.C.

The following are OCC's goals in supervising national banks: (1) to identify systemic and individual bank risks; (2) to determine banks' compliance with laws and regulations—including those regarding consumer protection, fair lending, and fiduciary activities, the Bank Secrecy Act, and the Community Reinvestment Act; (3) to address risks in a preventive manner that limits adverse impacts; and (4) to identify and require correction of problems in banks. OCC uses CAMEL ratings in assessing the condition of national banks.

OCC has tended not to conduct its examinations at one time. Rather, OCC targets particular areas of the bank to examine over the year until all areas of the bank are covered by examiners. Since the mid-1980s, OCC has permanently stationed on-site examiners at selected multinational banks and superregional banks.

³For both a joint and concurrent examination, the federal and the state regulators go into the bank at the same time. However, in a joint examination, the federal and state regulators issue a single report, while for a concurrent examination, the federal and state regulators issue a separate report.

⁴The Conference of State Bank Supervisors is the professional association of the state officials who charter, supervise, and regulate the nation's state-chartered banks.

⁵OCC has district offices in New York, Atlanta, Chicago, Kansas City, Dallas, and San Francisco.

Supervision of State
Nonmember Banks

Our hypothetical bank holding company has one state nonmember bank. Both FDIC and state banking departments supervise state nonmember banks. State nonmember banks are chartered by state banking departments and are not members of the Federal Reserve. FDIC uses CAMEL ratings in assessing bank condition.

FDIC's regional offices conduct full-scope examinations of state nonmember banks.⁶ In 1992, FDIC and the Conference of State Bank Supervisors entered into a joint resolution that specifies how cooperative examinations are to be undertaken between state banking departments and FDIC. This agreement allows each state banking department to participate in individual agreements with FDIC. According to the resolution, any bank that has a composite CAMEL rating of 1 or 2 would be examined by the state banking departments and FDIC on an alternate-year basis. FDIC and the Conference of State Bank Supervisors agreed to examine low-rated banks on an alternate-year, independent, joint, or concurrent basis, depending on the severity of the bank's problems.

Supervision of Nonbank
Subsidiaries

Section 4(c)(8) of the Bank Holding Company Act authorizes bank holding companies to engage directly or through a subsidiary in activities that the Board of Governors of the Federal Reserve determines are closely related to banking or managing or controlling banks.⁷ Many bank holding companies have established nonbank subsidiaries for this purpose.

Our hypothetical bank holding company owns nonbank subsidiaries at three organizational levels—the parent bank holding company, an out-of-state bank holding company, and the lead national bank. The Federal Reserve inspects those nonbank subsidiaries that are subsidiaries of bank holding companies. The responsible Reserve Bank, which supervises the parent bank holding company, is responsible for the supervision of all nonbank subsidiaries, regardless of location.

The Federal Reserve collects information on nonbank subsidiaries that are similar to but less detailed than information banks provide in their call reports. It also reviews information regarding the nonbank subsidiaries concurrently with the inspection of the parent holding company. After this

⁶FDIC has regional offices located in Atlanta, Boston, New York, Chicago, Dallas, Kansas City, Memphis, and San Francisco.

⁷Some of the activities of nonbank subsidiaries are consumer finance, trust services, leasing, mortgage, electronic data processing, insurance underwriters, management consulting services, and securities brokerage.

preliminary review, if the Federal Reserve determines that the nonbank subsidiary needs an on-site inspection, it sends examiners to inspect the nonbank subsidiary, otherwise on-site inspections are not conducted. In addition, nonbank subsidiaries of the lead national bank are examined by OCC. OCC has the authority to examine any subsidiary of a national bank.

In addition, the Federal Reserve has the authority to regulate all foreign branches of U.S. banks. All national banks and state member banks must receive permission from the Federal Reserve before they can open a foreign branch. Although the Federal Reserve has primary regulatory authority for foreign branches of U.S. banks, it defers its examination authority to OCC concerning foreign branches of national banks because OCC is the primary federal regulator of national banks.

Coordination in Supervision of Complex Banking Companies

Although the Federal Reserve is responsible for the holding company as a whole, it must often rely on OCC, FDIC, and state examiners for information about significant parts of the holding company. Conversely, OCC, FDIC, and the state regulators must rely on the Federal Reserve to provide information about the bank holding company and its ability to support the banks they supervise. Overlapping authority requires coordination among the various federal and state regulators as we discussed in chapter 5.

Since 1979, the Federal Reserve, OCC, and FDIC have been operating under an interagency agreement for coordinating bank holding company inspections and bank subsidiary examinations. The agreement requires the regulators to coordinate the bank holding company inspection and the examination of the lead bank subsidiary for (1) any bank holding company with assets that exceed \$10 billion, (2) any bank holding company or bank holding company subsidiary lead bank with a composite CAMEL rating of 4 or 5, and (3) any bank holding company or bank holding company subsidiary lead bank with a composite CAMEL rating of 3 whose financial condition appears to have worsened significantly since the last inspection or examination. This agreement was recently broadened; regulators now coordinate the bank holding company inspection with the lead bank examination for banking companies whose assets exceed \$1 billion.

Because of the increase in multitier bank holding companies, the Federal Reserve established general guidelines for interdistrict coordination for these multitier bank holding companies when the lower tier institutions are located in a district other than that of the parent holding company. Under the guidelines, the responsible Federal Reserve Bank coordinates

the inspections of the lower tier companies but relies on the local Federal Reserve Bank to conduct the on-site inspection function. The Federal Reserve Bank may provide an examiner-in-charge to head the inspection of any of the lower tier companies. The examiner-in-charge is responsible for coordinating the supervision of the entire banking company with the other Federal Reserve Banks.

The OCC district office that has supervisory authority over the lead national bank of a multinational bank holding company coordinates the examinations of the affiliated national banks in the banking company with the other regulatory agencies and OCC district offices.⁸ Using our hypothetical bank holding company, the OCC district in which our lead bank is located would oversee the supervision of the other three national banks in the bank holding company. This OCC district office may coordinate its supervisory activities with up to three OCC district offices.

Bank and Bank Holding Company Merger Process

If our hypothetical bank holding company wants to merge with another bank holding company or acquire another bank, it must obtain the approval of the Federal Reserve as stated in the Bank Holding Company Act.⁹

As in the supervision process, the regulators' jurisdiction also overlaps in the merger approval process. The Federal Reserve is responsible for all holding company mergers as well as for bank mergers involving state member banks. OCC and FDIC have jurisdiction over bank mergers in which the resulting bank is a national or state nonmember bank, respectively. In addition, a regulator may comment on any bank holding company merger involving the banks that it supervises. In a merger involving our hypothetical bank holding company, all three federal regulators may be involved in the merger process because the holding company owns national banks, state member banks, and a state nonmember bank.¹⁰

⁸If the national bank is one of the eight national banks supervised by OCC's multinational division, then the multinational division coordinates its supervision.

⁹Acquisitions refer to transactions in which the target bank or bank holding company remains a separate entity after the transactions. Mergers occur when the entity becomes part of its acquiror and disappears after the transaction. The term merger will be used to describe both types of transactions unless otherwise stated.

¹⁰State regulators may play a role in the merger process. The circumstances for state involvement differ by state. Some require approval if the resulting institution is state chartered, some if either organization is state chartered, and some regardless of the charter.

**Appendix III
Supervision and Regulation of a Multistate
Bank Holding Company**

The main purpose of the merger process is to ensure the safety and soundness of the resulting institution and the banking system as well as competition within banking markets. For example, the Bank Holding Company Act requires the Federal Reserve to consider several general criteria in deciding the outcome of a merger application. The criteria include financial and managerial resources and future prospects of the company or companies and banks concerned, the community's needs, and the competitive effects of the merger.¹¹

During the merger process, the regulators review the most recent examination report of each entity, paying particular attention to management quality, capital adequacy, and asset quality. If a bank involved in a merger has not been examined recently, the Federal Reserve may determine that more information is needed and may conduct another examination before approving the merger.

Most mergers are reviewed and approved at the regional or district level. The Federal Reserve Banks process all merger applications and depending on the complexity of the case, approve the merger or send it to the Board of Governors of the Federal Reserve for further review and action. At FDIC, bank merger applications are filed and for the most part, processed at its regional offices. OCC also allows merger approval at the district level for mergers meeting its expedited review process criteria.

¹¹Issues related to community needs and competitive considerations are discussed in chapters 6 and 7, respectively.

The Bank Merger Transaction: Financing and Accounting

Banking companies must generally turn to the capital markets to raise funds both to finance mergers and satisfy regulatory capital requirements. The choice of financing will determine the accounting method for the transaction or vice versa. These choices in turn will affect the tax liabilities created by the merger, the future earnings of the merged institution, and the final acquisition cost.

Financing

Bank mergers are financed with either cash or stock or some combination of cash, stock, or other securities.¹ If an acquiring bank pays cash to the shareholders of the target banking company, these shareholders will have no financial interest in the merged institution. The money paid for the acquired bank thus leaves the banking industry.

Most larger acquisitions that do not involve the purchase of a failed institution generally include exchanges of stock in their financing.² In a common stock transaction, the shares of the target banking company are exchanged for newly issued shares of the acquiring bank. Shareholders of the target banking company thus retain a financial interest in the merged institution.

The ability of a bank to raise capital is probably the most important factor in assessing the feasibility of an acquisition. It is important for two very distinct reasons: Strong book capital levels are needed to obtain regulatory approval of mergers, and high market capital values make acquisitions more affordable.

How Banking Companies Raise Capital

Banking companies are limited in the ways they can raise capital. They may either retain earnings or issue stock or qualifying debt. Banking institutions generally are not able to retain earnings quickly enough to finance larger acquisitions. Consequently, they must turn to the capital markets for funding, making them somewhat dependent on analysts' assessments of their expansion plans. If the shareholders disapprove of a merger, they can sell the bank's stock, thereby driving down its price and making the acquisition more expensive. If the merger is perceived as rewarding, stock will be purchased, with an upward price effect.

The price effect is important whether a merger is financed with cash or with an exchange of stock. In a cash transaction, the acquiring bank may

¹This discussion primarily pertains to publicly held banking organizations.

²The Resolution Trust Corporation and FDIC generally require cash for purchases of failed institutions.

have to issue new stock to raise the cash needed for the purchase. When a merger is financed through a stock exchange, new stock will be issued to the owners of the target banking company in exchange for their existing shares.

Book Value of Capital³

The Federal Reserve's policy requires that acquiring institutions must be well capitalized and that mergers do not result in a diminution of the overall book value of capital of the acquiring companies.⁴ If going into a merger an acquiring banking company has a risk-based capital level of 12 percent, it must generally maintain that level of capital after the acquisition. The lower the capital level of the acquired institution and the higher the purchase price, the more capital the acquiring bank must raise to meet this requirement.

Frequently banking companies will raise the capital necessary to acquire a target institution gradually. The Federal Reserve recognizes this and will generally judge the diminution of capital on the basis of the level of the acquiring bank's capital before it started raising funds for the acquisition.

Market Value of Capital

Whether a banking company can afford an acquisition has little to do with the company's book value capital but depends on the market value of its capital.⁵ The higher the market values of an acquiring bank's stock, the more affordable any acquisition will be, as the following simplified example illustrates.

BankUSA and BankWorld, bank holding companies of similar size, both wish to acquire BankTen, which they value at \$900,000. Both potential acquirors have 100,000 shares of stock outstanding with a book value of \$20 per share. However, BankUSA's stock sells at \$50 per share, while BankWorld's stock sells at only \$25 per share. To purchase BankTen, BankUSA must only issue 18,000 shares of stock, while BankWorld must

³The value of a bank's stock and eligible capital debt at the time they were issued multiplied by the number of shares outstanding plus cash. Without new capital issues, book value fluctuates with retained earnings or losses.

⁴The regulators say they generally use the definition of well-capitalized that the Federal Deposit Insurance Corporation Improvement Act of 1991 required regulators to develop. Under this definition, a well-capitalized bank must have (1) a tier 1 risk-based capital ratio of 6 percent or greater, (2) a total risk-based capital ratio of 10 percent or greater, and (3) a leverage ratio of greater than 5 percent. (The leverage ratio approximately corresponds to book value of equity divided by total assets.)

⁵The market value of capital is the price of a bank's stock multiplied by the number of shares of stock outstanding. The market value of a bank's capital can fluctuate on a daily basis depending on its stock value.

**Appendix IV
The Bank Merger Transaction: Financing
and Accounting**

issue twice as many shares. The acquisition is consequently easier for BankUSA to finance.

The reason the number of shares that must be issued to finance an acquisition is important—as important as, if not more than, the actual purchase price—is because of their effect on earnings dilution. Dilution is the effect a merger has on a bank's per share return. The higher the dilution, the lower the earnings per share, and the more difficult it will be to issue new stock to finance the merger. A further discussion of the example can help explain dilution. (Also see table IV.1.)

BankUSA and BankWorld earned \$750,000 in 1992, thus providing earnings per share of \$7.50 (i.e., \$750,000/100,000 shares). Because BankUSA had to issue 18,000 new shares to acquire BankTen, its earnings must be divided among 118,000 shares after the merger, diluting earnings per share by 15 percent to \$6.36.⁶ In addition, BankWorld's post-merger earnings are divided among 136,000 shares, resulting in earnings per share of \$5.52 and a dilution of more than 26 percent.

Table IV.1: Value and Earnings of BankUSA and BankWorld

	BankUSA	BankWorld
Shares outstanding	100,000	100,000
Book value per share	\$20	\$20
Market value per share	\$50	\$25
Earnings per share (premerger)	\$7.50 ^a	\$7.50 ^a
Earnings per share (post-merger)	\$6.36 ^b	\$5.52 ^c
Earnings per share dilution	15%	26%

^a\$750,000/100,000 = \$7.50.

^b\$750,000/118,000 = \$6.36.

^c\$750,000/136,000 = \$5.25.

Bank analysts told us that markets generally look with disfavor at mergers that dilute earnings per share more than 3 percent at the time of acquisition and that take longer than 2 or 3 years to make up any dilution through increased revenues or reduced costs. The higher the dilution, the greater the pressure on a banking company to quickly increase revenues, often through high annual growth.

⁶To simplify this discussion, we assumed that BankTen will not contribute earnings to the combined organization. We also do not allow for potential cost savings from the merger that might increase earnings.

Concerns about dilution are greatest in mergers involving banks of like sizes, because such mergers generally require relatively large issuances of new stock over which earnings must then be spread. If, on the other hand, a bank with \$100 billion in assets acquires a bank with \$100 million or even one with assets of \$1 billion, the degree of dilution is likely to be minimal because relatively little new stock must be issued to finance the purchase. Thus, at least in the short term, large, well-capitalized banks are less constrained by the market when acquiring smaller banks. However, if a string of small acquisitions is perceived as being costlier than, for example, an acquisition of a single larger bank, then the acquiring bank's stock could suffer in the long term.

Industry experts also told us that regulatory capital requirements are generally more of a constraint on acquisitions than are the stockholders' concerns about earnings dilution. Although bank managers have a fiduciary responsibility to their stockholders, projections of revenue improvements and cost savings from an acquisition are by nature uncertain and may consequently be presented optimistically to increase the attractiveness of a merger. Regulatory requirements, on the other hand, are very specific and strongly enforced. In the long run, however, the markets will judge bank management by its performance in past mergers, and if promises have not been kept, then financing for future mergers will become more expensive.

Accounting Methods

The two accounting methods used for bank mergers and acquisitions are (1) pooling of interest and (2) purchase.

In pooling-of-interest transactions, the balance sheets (i.e., assets and liabilities) of the two banking companies are simply added together, item by item. An important benefit of structuring mergers so that the pooling-of-interest method of accounting can be used is that it is a nontaxable transaction. Neither the buyer nor the seller is forced to recognize a gain or loss on the exchange of shares in the merger. This may be an important factor in the buyer's ability to convince the bank owners to sell their shares. In addition, when a merger is structured so that the pooling-of-interest method of accounting is used, goodwill will not be created because the assets and liabilities are simply added together without any revaluation. Therefore, there will be no goodwill to amortize against future earnings. One possible disadvantage of structuring mergers so that the pooling-of-interest method can be used is that the buyer must

assume all of the assets and liabilities of the seller, including any unknown or contingent liabilities.

When mergers are structured so that the purchase method of accounting must be used, the acquiror treats the target banking company as an investment and may revalue certain assets and liabilities on the target banking company's balance sheet. This revaluation may create goodwill that must be written off against future earnings over a period of several years (usually 10 to 15 years). In some cases, this annual write-off makes this type of transaction unattractive because it has a very large impact on annual earnings.⁷ In addition, in purchase acquisitions, the sale or transfer of stock is treated as a taxable event.

Whether the pooling-of-interest or the purchase accounting method is used is determined by the structure of the merger. Any transaction that does not meet the criteria for pooling-of-interest accounting must use the purchase method. Generally, the pooling-of-interest method can be used only when the merging parties are independent, the combination will be completed within 1 year, the acquiring bank issues its regular common stock in exchange for at least 90 percent of the common stock in the other company, and there are no future buy-out agreements or plans to sell a significant part of the assets of the merged banks within 2 years.

⁷There are several other more specific advantages and disadvantages of these structuring options that might influence the final merger structure and the accounting method used, but they are beyond the scope of this report.

Efficiency and Economies of Scale

One of the factors driving the response to a change in interstate banking laws will be market perceptions of opportunities to increase efficiency and benefit from economies of scale—in which average cost declines as bank output or size increases. The realization of such gains could improve individual bank profitability and increase the banking industry's market share of certain financial services if banks were able to become lower cost producers.

Part of the debate on expanded interstate banking and branching centers on whether large banks have lower costs of production, merely because of their size, than smaller banks. Differing definitions of bank costs and outputs, methodologies, data, and results have made it difficult to form a clear and unambiguous conclusion about the extent of economies of scale.¹ The general consensus of studies dating back over almost 30 years is that scale economies do not exist in banking, except in small banks usually estimated to have less than \$100 million in assets. Many studies show that larger banks experience either constant costs or slight diseconomies.²

A number of studies over the past decade have focused specifically on larger banks, usually those with more than \$1 billion in assets. Some of these studies have found economies of scale in banks with up to \$2 billion in assets and others with up to \$10 billion in assets but found diseconomies of scale thereafter. These results suggest that bank costs vary substantially depending on the range of bank sizes included in the sample and could be due, at least in part, to the different products produced by large and small banks. A recent study that purports to deal with these problems found that substantial scale economies exist for

¹The literature is divided over the issue of the appropriate definition of bank output and consequently bank cost. Two measures of output are most often used—dollar volumes in accounts and number of accounts. Ideally, bank output should be measured as a flow of services and products produced, but because of data limitations stock measures are used. Bank costs are defined as either operating costs (noninterest expenses) or total costs.

Two sources of data have most frequently been used. The Federal Reserve's Functional Cost Analysis survey collects cost information on a voluntary basis from 400 to 600 banks. These data typically exclude banks with more than \$1 billion in assets because of the low participation rate of these banks. Moreover, the same banks are not in the sample each year. Call report data are the other source. These data cover all banks in the United States, but costs are not allocated to specific functions as they are in the Functional Cost Analysis data.

Finally, differences exist in the choice of a cost function. Early studies generally used a function that did not allow for variation in costs between different sized banks. It assumed that the cost curve facing all banks was the same.

²Similar results have been found regarding economies of scope—where the joint production of two or more products or services is cheaper than the production of each individually. Overall, there is no consistent evidence that general economies of scope exist.

banks with up to \$500 million in assets and that there is generally no advantage or disadvantage beyond \$500 million.³

If significant economies of scale do not exist except in smaller banks, then only those smaller banks that are operating under scale diseconomies are at a cost disadvantage relative to larger banks. While smaller banks may reduce their costs simply by growing, larger banks will not gain a similar advantage simply by growing. Consequently, the development of a natural monopoly in banking is unlikely.

Although there may be no advantages from general economies of scale through growth, a number of bankers and industry analysts believe that improvements, from the creation of larger banks through mergers, are possible in two areas. First, they believe that economies of scale are present in several market or product lines with high fixed costs. Consulting firms working with cost data provided by individual banks have found scale economies in branch networks, check clearing, centralized customer service, credit card lending, and home mortgage lending and processing. According to several studies, the key to success in achieving economies of scale lies in the ability of the banking company to focus on a limited set of business lines. This may help explain why general economies of scale have not been found in the banking industry.

Second, many of the studies testing for economies of scale assume that banks produce their services with similar degrees of efficiency. Academic research and projections by management consultants regarding the benefits of merging well-run banks with less well-run banks show that this assumption is incorrect. Among banks of similar size, substantial variation exists in operating costs.

The potential to decrease costs by increasing managerial efficiency is thought to be relatively large. Most of the projections for significant cost savings from bank mergers come from predictions that assume that the most efficiently run banks will acquire less well-run banks. While these savings may be possible, they are not the result of achieving economies of scale. If economies of scale exist, these savings would be in addition to any savings from such economies.

The evidence that economies of scale in banking are limited is reflected in the structure of today's banking industry. If banking technology resulted in

³McAllister, Patrick H., and Douglas McManus, "Resolving the Scale Efficiency Puzzle in Banking." Board of Governors of the Federal Reserve System. November 1992.

Appendix V
Efficiency and Economies of Scale

general economies of scale, we would expect banking companies to be large. Alternatively, if there were diseconomies of scale, small specialized banks could be expected to dominate. In the absence of either, a mixture of bank sizes would be likely, as is the case in the United States today. Furthermore, on the basis of results of economies of scale studies, this structure is likely to continue regardless of changes in interstate banking or branching laws, although the smallest banks may be at a disadvantage relative to all other banks.

Organizations Interviewed

Financial Institutions

Banc One Corporation—Columbus, Ohio
BankAmerica Corporation—San Francisco, California
Bank of Boston—Boston, Massachusetts
Bank of New York Company—New York, New York
Bankers Trust New York Corporation—New York, New York
Chase Manhattan Corporation—New York, New York
Chesapeake Bank and Trust Company—Chestertown, Maryland
Citicorp—New York, New York
Civic Bank of Commerce—Oakland, California
Crestar Financial Corporation—Richmond, Virginia
First Union Corporation—Charlotte, North Carolina
First Virginia Bank, Inc.—Falls Church, Virginia
NationsBank—Charlotte, North Carolina
Natwest Holdings, Inc.—New York, New York
Norwest Corporation—Minneapolis, Minnesota
Signet Banking Corporation—Richmond, Virginia
SouthTrust Corporation—Birmingham, Alabama
SunTrust Banks, Inc.—Atlanta, Georgia
The Better Banks Company—Peoria, Illinois
U.S. Bank—Seattle, Washington
Virginia Community Bank—Louisa, Virginia
Wachovia Bank and Trust—Winston-Salem, North Carolina
Wells Fargo Bank—San Francisco, California

Bank Regulatory Agencies

Bank Commissioner, State of Maryland
Board of Governors of the Federal Reserve System
Commissioner of Financial Institutions, State of Virginia
Federal Deposit Insurance Corporation
Federal Reserve Bank of Atlanta
Federal Reserve Bank of Minneapolis
Federal Reserve Bank of New York
Federal Reserve Bank of Richmond
New York State Banking Department
Office of the Comptroller of the Currency
Office of Thrift Supervision

Other Federal Agencies

Bureau of the Census, Foreign Trade Division
Department of Commerce, International Trade Administration
Department of Justice
Export-Import Bank

**Appendix VI
Organizations Interviewed**

**Office of Management and Budget
Small Business Administration**

**State Government
Agencies**

**Colorado International Trade Office
Connecticut Department of Economic Development, International Division
Florida Department of Commerce, Bureau of International Trade and
Development
Maine State Development Office
Massachusetts Office of International Trade and Investment
Minnesota Trade Office
New Hampshire Department of Resources and Economic Development
North Carolina Department of Economic and Community Development,
International Division
Pennsylvania Department of Commerce, International Trade and
Economic Affairs Department
Port Authority of New York/New Jersey
Washington State Department of Trade and Economic Development
Washington State Office of the Attorney General**

**Public Interest
Organizations**

**Association of Community Organization for Reform Now
American Association of Retired People
Center for Community Change
Center for Policy Alternatives
Consumer Action
Consumer Federation of America
Southern Finance Project**

**Banking and Trade
Associations**

**American Association of Exporters and Importers
American Bankers Association
American Countertrade Association
Association of Bank Holding Companies
Bankers Association for Foreign Trade
Conference of State Bank Supervisors
Export Assistance Center of Washington—Seattle, Washington
Financial Services Council
Independent Bankers Association of America
Institute of International Bankers
National Association of Attorneys General
National Council for Urban Economic Development**

**Appendix VI
Organizations Interviewed**

National Federation of Independent Business
National Small Business United
Small Business Exporters Association
U.S. Chamber of Commerce

Other

Bear Stearns
Brookings Institution
Clearing House Interbank Payment System
Danielson Associates
Deloitte and Touche
First Boston Corporation
First Manhattan Consulting Group
Furash and Company
Global American Capital Group
International Monetary Fund
Keefe, Bruyette, and Woods, Inc.
K.H. Thomas Associates
Moody's Investors Service
Shearson Lehman Hutton
Skadden Arps
Smith Barney, Harris Upham, and Company Inc.
Standard & Poor's
Sullivan and Cromwell
S.W.I.F.T.
The Secura Group
University of California at Berkeley, Haas School of Business
Urban Institute

Comments From FDIC

FDIC

Federal Deposit Insurance Corporation
Washington, DC 20429

Office of Executive Director
Supervision and Resolutions

October 18, 1993

Mr. James L. Bothwell
Director, Financial Institutions
and market Issues
General Accounting Office
Washington, D. C. 20548

Dear Mr. Bothwell:

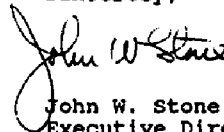
Acting Chairman Hove requested I respond to your letter of September 27, 1993 asking for comment on a draft report entitled, Banking Regulation: Benefits and Risks of Removing Interstate Banking and Branching Restrictions.

We have reviewed the draft report and have no substantive comment on its contents or conclusions. For your information, Mr. Hove testified on this subject before the Senate Committee on Banking, Housing, and Urban Affairs on October 5, 1993. As a general matter, the FDIC supports the relaxation of the geographic and product restraints on banks provided that the states continue to play a role in the transition.

The bank insurance fund has absorbed major losses in recent years in rescuing large banking organizations with assets concentrated in a few industries or in a limited geographic area. During the 1980s, for example, slightly more than 80 percent of failed-bank assets were in just four states: Texas, Illinois, New York, and Oklahoma. Perhaps if they had been more geographically diversified, banks in these states might have been better able to weather the financial storms that beset local and regional energy, agricultural, and real estate markets.

We appreciate the opportunity to review the draft report.

Sincerely,



John W. Stone
Executive Director

Comments From the Department of the Treasury



UNDER SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON

October 25, 1993

Dear Mr. Bothwell:

Thank you for your September 27 letter to Secretary Bentsen, enclosing the draft of the GAO report on Banking Regulation: Benefits and Risks of Removing Interstate Banking and Branching Restrictions.

We have no formal comments, but we appreciate receiving the report. Upon examination we found it to be an impressive and thoughtful survey of the issues and evidence involved. We trust that this report will be useful background information for the current Congressional review of nationwide banking and branching.

Sincerely,

A handwritten signature in cursive script that reads "Frank N. Newman".

Frank N. Newman
Under Secretary of the Treasury
Domestic Finance

Mr. James L. Bothwell
Director
Financial Institutions and
Markets Issues
General Accounting Office
441 G Street, NW
Washington, DC 20548

cc: Comptroller General of the
United States Charles A. Bowsher

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Glossary

Bank Holding Company	A corporation that controls at least one bank.
Banking Company	One or many banks that belong to a single entity.
Community Bank	A banking company with less than \$1 billion in banking assets.
Compact	A term that is used relatively loosely in describing regional reciprocal banking laws.
Concentration Ratio	A measure of the amount of business handled by a specified number of the largest banking companies.
De Novo	A new bank or branch office.
Firewall	A term that refers to regulations meant to segregate a bank's securities underwriting from its deposit-gathering and lending activities.
Herfindahl-Hirschman Index (HHI)	An index of concentration computed by summing the square of the market share of each firm in the industry.
Independent Bank	A bank that is not controlled by a bank holding company.
In-Market Merger	A merger between banks that operate in substantially overlapping markets.
Interstate Branching	An arrangement that permits banks to branch across state borders.

Glossary

Limited Branching	An arrangement that restricts in-state bank branches, usually by number or by distance from where they are headquartered.
Market Extension Merger	A merger between banks that operate in minimally overlapping markets.
Nationwide Banking	An arrangement that permits bank holding companies to operate subsidiary banks in any state regardless of where the holding companies are headquartered.
Nationwide Reciprocal Banking	An arrangement whereby a state limits the entry of out-of-state bank holding companies to those states where its bank holding companies are permitted to enter.
Nonbank Subsidiary	Any business other than a commercial bank operated by a bank holding company.
Regional Reciprocal Banking	An arrangement whereby a state designates from which states it will permit the entry of bank holding companies. Entry is limited to banks from states within a specific region and is permitted only if those states offer reciprocity.
Reserve Bank	Any of the 12 district Federal Reserve Banks.
Statewide Branching	An arrangement that allows banks to operate a branch anywhere within a state.
Superregional Bank	A nonmoney center bank, ranking among the largest banking companies in the United States, that has merged across state lines to establish a full banking presence in another state.

Glossary

Tripwire

A term that refers to the system of mandatory enforcement actions established by FIDICIA that bank regulators must take based on a bank's level of capital.

Unit Banking

An arrangement that prohibits banks from offering full services anywhere but their headquarters. Branching is not permitted.

Related GAO Products

Banks and Thrifts: Safety and Soundness Reforms Need to Be Maintained
(GAO/T-GGD-93-3, Jan. 27, 1993).

Thrift Examination Quality: OTS Examinations Do Not Fully Assess Thrift Safety and Soundness (GAO/AFMD-93-11, Feb. 16, 1993).

Bank Examination Quality: FDIC Examinations Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-12, Feb. 16, 1993).

Bank Examination Quality: FRB Examinations and Inspections Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-13, Feb. 16, 1993).

Bank Examination Quality: OCC Examinations Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-14, Feb. 16, 1993).

Bank and Thrift Regulation: Improvements Needed in Examination Quality and Regulatory Structure (GAO/AFMD-93-15, Feb. 16, 1993).

Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991).

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