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INTERSTATE BANKING: MYTH AND REALITY

*H. Rodgin Cohen**

I. INTRODUCTION

Recent legislative, judicial and economic developments have intensified the debate over whether long-standing federal limitations on interstate banking should be liberalized or even eliminated. The debate over interstate banking, however, suffers from two basic flaws.

First, the terms of the debate are not understood. The issue is not whether interstate banking should exist. Comprehensive interstate banking already exists in a variety of forms. Yet, the existence of interstate banking does not mean that the debate is irrelevant. Rather, the specific question for debate is whether financially healthy banking organizations¹ should be permitted to merge or acquire one another without regard to state boundary lines.

Second, the debate over interstate banking has not been placed in a proper historical perspective. Congress dealt with interstate banking in 1927, 1933, 1956 and, to a limited extent, in 1982. A review of the congressional debates reveals that Congress' three principal concerns were economic concentration, bank safety and soundness, and competitive equality. The interstate banking debate has failed to focus on whether these concerns remain relevant today and how, if relevant, they should now be addressed.

Only when the terms of the debate are understood is it possible to analyze properly the advantages and disadvantages of legislative action liberalizing the restrictions on interstate banking. Only when past congressional objectives and perceptions are recognized is it possible to determine whether and how those objectives remain relevant today. It is the thesis of this Article that legislative liberalization of interstate banking is supported by a reexamination of both the existing interstate banking structure and the congressional rationale behind the current statutory restrictions.

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1. For purposes of this Article, the term "banking organizations" refers to both banks and bank holding companies.

II. HISTORICAL PERSPECTIVE, ANALYSIS AND DISCUSSION

A. Background

1. Federal legislative structure

The federal legislative restrictions on interstate banking consist primarily of: (1) a prohibition on interstate branching;² and (2) a restriction on interstate bank acquisitions.³

The federal branching prohibitions, popularly referred to as the McFadden Act, were adopted in 1927 and modified in 1933.⁴ Congress' objectives in originally adopting the McFadden Act have been misunderstood. Focusing on the enactment of 12 U.S.C. section 36, which in 1927 permitted national banks to branch only within a single city, some commentators have viewed the McFadden Act as restricting national bank branching. Other commentators have argued that the 1927 McFadden Act was intended to expand branching power in view of a 1924 Supreme Court ruling that national banks lacked *any* branching authority.⁵

Both of these views are incorrect. The principal focus of Representative McFadden in 1927 was not on national bank branching, but instead on the absence of any restriction on branching by state banks. Consequently, the more critical provision of the McFadden Act was the amendment of section 9 of the Federal Reserve Act⁶ to restrict branching by state banks which were members of the Federal Reserve System.⁷

Congress had two objectives in enacting the McFadden Act in 1927. The first was to prevent undue economic concentration.⁸ The second was to prevent state banks from having a substantial advantage over national banks by reason of their then broader branching power.⁹ At the

2. 12 U.S.C. §§ 36, 355 (1982).

3. 12 U.S.C. § 1842(d) (1982).

There are also a wide variety of state law limitations on interstate banking. *See, e.g.,* N.Y. BANKING LAW § 200 (McKinney 1980); 7 PA. CONS. STAT. ANN. § 105 (Purdon 1967 & Supp. 1984-1985). Although the constitutionality of these state statutes has apparently never been challenged in a judicial forum, the landmark Supreme Court case on interstate banking expansion creates at least a significant question on the constitutionality of these statutes under the commerce clause. *See* Lewis v. BT Inv. Managers, 447 U.S. 27 (1980).

4. 12 U.S.C. § 36(c) (1982).

5. *See* First Nat'l Bank in St. Louis v. Missouri, 263 U.S. 640 (1924).

6. 12 U.S.C. § 335 (1982).

7. S. REP. NO. 666, 68th Cong., 1st Sess. 1 (1924); 68 CONG. REC. 2166 (1927) (statement of Rep. McFadden).

Although the McFadden Act applies only to banks which are members of the Federal Reserve System, the opportunity for interstate expansion by nonmember banks has apparently never been utilized.

8. 66 CONG. REC. 1649-50 (1925) (statement of Rep. McFadden).

9. H.R. REP. NO. 583, 68th Cong., 1st Sess. 1, 3 (1926).

same time, the potential of any advantage for national banks was negated by confining their limited branching authority to that permitted for a state bank.¹⁰

In the seminal Banking Act of 1933,¹¹ the McFadden Act was amended to permit national banks to expand on a statewide basis to the extent permitted for state banks. This amendment represented a compromise between the Senate and the House. In 1932, the Senate had passed a bill¹² which would have permitted statewide branching without reference to state law and interstate branching within a 50 mile "trade area." The House was strongly opposed to any liberalization of the branching restrictions.¹³

The principal objective of the 1933 expansion of branching authority was the promotion of bank safety and soundness.¹⁴ Senator Carter Glass, the Senate's dominant expert on banking matters, had been a strong proponent of the 1927 branching limitations. He subsequently became convinced, by the ensuing closing of thousands of banks, that his original views were incorrect. Stressing the correlation between restrictions on branching and the magnitude of bank closings, he urged expanded branching powers as a solution.¹⁵ The Senate opponents of expanded branching authority based their arguments on concern over economic concentration.¹⁶

The compromise decision to confine branching expansion to state borders was unaccompanied by any detailed analysis of why the state, rather than a larger or smaller geographic area, was appropriate. There was no indication that Congress regarded the state as an economic unit. Indeed, an historical analysis would demonstrate that state boundary lines were not drawn for such purpose, much less to follow the demands of banking customers. The determination may well have been influenced by the fact that in 1933 only two banks had multi-state branches.¹⁷

10. 68 CONG. REC. 2166 (1927) (statement of Rep. McFadden).

11. 12 U.S.C. §§ 24, 78, 377, 378 (1982). This Act was popularly known as the Glass-Steagall Act. It also contained provisions establishing the federal deposit insurance program and the separation of commercial and investment banking.

12. S. 4412, 72d Cong., 1st Sess. (1932).

13. The Senate bill was misinterpreted by a number of congressmen as permitting full interstate banking with state acquiescence. 76 CONG. REC. 1333 (1933) (statement of Sen. Wheeler).

14. S. REP. NO. 79, 73d Cong., 1st Sess. 11 (1933).

15. 75 CONG. REC. 9890 *passim* (1932); 76 CONG. REC. 1405 (1933) (statement of Sen. Glass).

16. S. REP. NO. 584, Part II, 72d Cong., 1st Sess. 3 (1932) (minority views); 75 CONG. REC. 10,055 (1932) (statement of Sen. Blaine).

17. The two banks with multi-state branches, which predated the 1927 McFadden Act,

The federal limitations on interstate banking through bank acquisitions were established by section 3(d) of the Bank Holding Company Act of 1956.¹⁸ Section 3(d) is popularly known as the Douglas Amendment. It generally provides that the Federal Reserve Board may not approve an application by a bank holding company to acquire a bank located outside the holding company's principal state of operations.¹⁹ The Douglas Amendment does, however, authorize individual states to authorize acquisitions by out-of-state bank holding companies.²⁰ In contrast, there is no authority under the McFadden Act for states to authorize interstate branching.

The Douglas Amendment represented a compromise between a House bill,²¹ which contained a flat bar on interstate acquisitions, and a Senate bill,²² which contained no limitation. Although the legislative debates contain several references to state rights, Senator Douglas made it clear that his Amendment was intended to check undue bank concentration.²³

Both proponents and opponents of the Douglas Amendment assumed that it was unlikely that states would authorize out-of-state entry. This assumption proved to be accurate for the first twenty-five years following the Douglas Amendment. In the last three years, however, a number of states have authorized out-of-state entry.²⁴

were Heritage Bank (of New Jersey) with a branch in Philadelphia and Bank of California with branches in Oregon and Washington. The Board of Governors of the Federal Reserve System (Federal Reserve Board) has sought to preclude these interstate branches from being used as a vehicle for further interstate expansion. *See, e.g., Mellon Nat'l Corp.*, 70 Fed. Res. Bull. 441 (1984), *aff'd sub nom. Girard Bank v. Board of Governors*, 748 F.2d 838 (3d Cir. 1984); *Mitsubishi Bank Ltd.*, 70 Fed. Res. Bull. 518 (1984).

18. 12 U.S.C. § 1842(d) (1982).

19. This limitation on the Federal Reserve Board's authority is tantamount to a prohibition because all bank acquisitions (except bank mergers) must be approved by the Board under § 3(a) of the Bank Holding Company Act. 12 U.S.C. § 1842(a) (1982). Interstate bank mergers would normally violate the McFadden Act. 12 U.S.C. § 36(c) (1982).

20. The types of state statutes which are permissible under the Douglas Amendment and the nature of the state action required have been the subject of numerous judicial and regulatory actions. *Northeast Bancorp v. Board of Governors*, 740 F.2d 203 (2d Cir. 1984), *cert. granted*, 105 S. Ct. 776 (1985); *Iowa Indep. Bankers Ass'n v. Board of Governors*, 511 F.2d 1288 (D.C. Cir.), *cert. denied*, 423 U.S. 875 (1975); *First Bank Sys.*, 70 Fed. Res. Bull. 771 (1984); *Bank of New York Co.*, 70 Fed. Res. Bull. 527 (1984); *Mellon Nat'l Corp.*, 70 Fed. Res. Bull. 441 (1984), *aff'd sub nom. Girard Bank v. Board of Governors*, 748 F.2d 838 (3d Cir. 1984); *NCNB Corp.*, 68 Fed. Res. Bull. 54 (1982).

21. H.R. 6227, 84th Cong., 2d Sess. (1956).

22. S. 2577, 84th Cong., 2d Sess. (1956).

23. 102 CONG. REC. 6857 (1956) (statement of Sen. Douglas).

24. Two states, Alaska and Maine, have authorized entry on an unlimited basis; one state, New York, has authorized entry on a "reciprocal" basis; eight states, Massachusetts, Connecticut, Florida, Georgia, South Carolina, North Carolina, Virginia and Maryland, have author-

The existing federal structure has not been comprehensively reexamined by Congress in almost thirty years. The Douglas Amendment was amended in 1982 by Title I of the Garn-St Germain Act²⁵ to provide for interstate acquisitions of failed banks which had at least \$500 million in assets. Congress adopted this revision in order to provide stability to the banking system.²⁶

2. Existing forms of interstate banking

Notwithstanding this pervasive legislative pattern, interstate banking has become a fundamental element of the banking industry. "The McFadden-Douglas wall remains intact, but market forces are surging around and over it."²⁷ Such a result is seemingly inevitable because the "financial services industry is inherently an interstate business."²⁸ To some extent, the existing interstate banking structure reflects conscious legislative decisions. To an even greater extent, the structure reflects technological, regulatory and economic changes which Congress has not confronted.

a. section 4(c)(8) of the Bank Holding Company Act

The principal source of interstate banking is section 4(c)(8) of the Bank Holding Company Act,²⁹ which permits bank holding companies and their subsidiaries to engage in activities which are "so closely related to banking . . . as to be a proper incident thereto."³⁰ The Douglas Amendment restrictions apply only to interstate acquisitions of "banks."³¹ In contrast, section 4(c)(8) contains no geographic limitation

ized entry on a "regional reciprocal" basis; and two states, Kentucky and Rhode Island, have authorized entry on a "regional reciprocal" basis with a "national reciprocal" trigger. In addition, several states, e.g., Delaware, have authorized out-of-state acquisitions of credit card or limited wholesale banks, several, e.g., Iowa, have enacted special grandfather statutes, and several, e.g., Illinois, have authorized acquisitions of failing banks.

25. Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified in scattered sections of 12 U.S.C.).

26. See *Capital Assistance Act and Deposit Insurance Flexibility Act: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs on S. 2531 and S. 2532*, 97th Cong., 2d Sess. 122 (statement of Hon. C. Todd Conover, Comptroller of the Currency), 168 (statement of Roger W. Mehle, Jr., Assistant Secretary of the Treasury) (1982).

27. *Special Issue: Interstate Banking*, ECON. REV., May 1983, at 2 (Federal Reserve Bank of Atlanta).

28. REPORT OF THE PRESIDENT, DEP'T OF THE TREAS., GEOGRAPHIC RESTRICTIONS ON COMMERCIAL BANKING IN THE UNITED STATES 2 (Jan. 1981) [hereinafter cited as PRESIDENT'S REPORT].

29. 12 U.S.C. § 1843(c)(8) (1982).

30. *Id.*

31. The term "bank" is defined in § 2(c) of the Bank Holding Company Act, 12 U.S.C.

on expansion by bank holding company subsidiaries which are not "banks," even if these subsidiaries provide substantial banking services.

Somewhat surprisingly, Congress does not appear to have considered the question of whether there should be geographic limits on bank holding subsidiaries other than banks. Prior to the 1970 amendments to the Bank Holding Company Act,³² the Federal Reserve Board generally restricted expansion by nonbanking subsidiaries of bank holding companies to the state in which the holding company was principally located.³³ Although the present section 4(c)(8) was substantially rewritten in the 1970 amendments to the Bank Holding Company Act,³⁴ the congressional debate focused on whether the revision expanded the range of permissible activities rather than where the activities could be performed.³⁵

Nonetheless, the Federal Reserve Board evidently interpreted the 1970 amendments as eliminating geographic restraints.³⁶ Subsequent state efforts to limit expansion under section 4(c)(8) have been held to be unconstitutional.³⁷

Acting under section 4(c)(8), a number of large bank holding companies have been able to establish a national presence for lending and other financial services. There is approximately one interstate section 4(c)(8) office for every six bank branches.

The principal method of geographic expansion has been through acquisition of finance companies. In the early and mid-1970's the Federal Reserve adopted a restrictive policy on such acquisitions on competitive grounds.³⁸ Under the Federal Reserve's most recent decisions, however, virtually no finance company acquisition would be denied on competitive grounds.³⁹ There are now approximately 6000 interstate offices of bank holding company finance company subsidiaries. Other major forms of geographic expansion under section 4(c)(8) have been in mortgage bank-

§ 1841(c) (1982), as a company which *both*: (1) accepts demand deposits; and (2) engages in the business of making commercial loans.

32. Pub. L. No. 91-607, 84 Stat. 1760 (codified as amended at 12 U.S.C. §§ 1841-1843, 1849, 1850 (1982)).

33. See General Contract Corp., 44 Fed. Res. Bull. 260 (1958).

34. 12 U.S.C. § 1843(c)(8) (1982).

35. Compare H.R. REP. NO. 1747, 91st Cong., 2d Sess. 13-22 (1970) with S. REP. NO. 1084, 91st Cong., 2d Sess. 12-13 (1970).

36. The Federal Reserve did not articulate a rationale for this reversal of position. See Federal Reserve Bank of New York Circular No. 6677 at 3 (1971).

37. *Lewis v. BT Inv. Managers, Inc.*, 447 U.S. 27 (1981); *Continental Illinois Corp. v. Lewis*, No. 81-944 (N.D. Fla. Dec. 31, 1983).

38. See *Chase Manhattan Corp.*, 60 Fed. Res. Bull. 874 (1974) (not allowing acquisition of Dial Finance).

39. See *Manufacturers Hanover Corp.*, 70 Fed. Res. Bull. 452 (1984) (approving acquisition of CIT Financial).

ing (approximately 700 interstate offices), leasing, trust services, insurance, and industrial banks.

Prior to 1984, the Federal Reserve Board had been generally unwilling to approve section 4(c)(8) subsidiaries which engaged in retail deposit-taking.⁴⁰ Limited exceptions were made for industrial banks and failing thrift organizations. The Federal Reserve's stated reason for this position was a possible conflict with the policy of the Douglas Amendment.⁴¹

In March, 1984, however, the Federal Reserve opened the door to interstate retail deposit-taking under section 4(c)(8) by approving the first "nonbank bank" subsidiary of a bank holding company.⁴² Since that date, applications have been filed for over 300 nonbank bank charters.⁴³

Interstate subsidiaries established under section 4(c)(8) have been primarily the province of the largest bank holding companies. All of the ten largest bank holding companies and 48% of the fifty largest have such subsidiaries, but only about 1% of the bank holding companies below the top 150 have such subsidiaries.⁴⁴ Not surprisingly, these subsidiaries are concentrated in the most attractive banking markets, with California, Florida and North Carolina ranking as the top three states in terms of such subsidiaries.

b. loan production offices

Many larger banks operate so-called loan production offices (LPOs) on an interstate basis. These offices are not branches in violation of the McFadden Act because the loans are considered to be "made" from the home office.⁴⁵ The offices do, however, actively solicit loan business from

40. See D.H. Baldwin Co., 63 Fed. Res. Bull. 280 (1977) (denying application to acquire savings and loan associations).

41. 12 U.S.C. § 1842(d) (1982).

42. U.S. Trust Corp., 70 Fed. Res. Bull. 371 (1984). A nonbank bank is an institution with a bank charter, but which is not subject to the Douglas Amendment because it is not defined as a "bank" under § 2(c) of the Bank Holding Company Act. *Id.* at 372. See *supra* note 31.

43. The feasibility of the nonbank bank has been thrown into question by a recent decision holding that the Comptroller of the Currency lacked the authority to charter such an institution and the Federal Reserve Board's determination not to process additional applications in light of this decision. IBAA v. Conover, No. 84-1403 (M.D. Fla. Feb. 15, 1985); Federal Reserve Board, Press Release (Mar. 15, 1985).

44. See Whitehead, *Interstate Banking: Taking Inventory*, ECON. REV., May 1983, 4, 9 (Federal Reserve Bank of Atlanta).

45. See 12 C.F.R. §§ 5.20, 250.141(h) (1985). Under 12 U.S.C. § 36(f) (1982), a branch "include[s] any . . . office . . . at which deposits are received, or checks paid, or money lent." Various procedural arrangements, relating among other things to credit approval and funds

larger and, increasingly, medium-sized companies. It is estimated that there are now approximately 375 interstate loan production offices.

The establishment of loan production offices does more than generate loan business. The establishment of an interstate loan production office to develop corporate loan relationships "has usually meant that [corporate] deposits also have flowed interstate."⁴⁶

c. Edge corporations

Edge corporations have been established under section 25(a) of the Federal Reserve Act⁴⁷ to provide international banking services. There are no geographic restrictions on Edge corporations, and expansion was encouraged by a 1979 liberalization of the Federal Reserve Board's regulations governing Edge corporations.⁴⁸ There are approximately 150 interstate offices of Edge corporations, the great majority of which are owned by the largest banking organizations.

d. grandfathered bank holding companies

The Douglas Amendment did not affect the status of then existing multi-state bank holding companies.⁴⁹ Four of these grandfathered holding companies have more than 900 interstate offices. The largest, First Interstate Bancorp, which is headquartered in California, has deposits of approximately \$20 billion in banks located in ten other states. Under a series of judicial decisions, these grandfathered bank holding companies have been permitted to expand, through bank mergers, in the states in which they had banks prior to 1956.⁵⁰

e. automated teller machines

Numerous automated teller machines (ATMs) have been established which permit, on a shared basis, access to out-of-state deposit accounts for both withdrawals and deposits. In describing the growth of interstate ATM systems, one commentator noted that: "[E]lectronic funds transfer

disbursement, are followed to preserve this distinction. There has been no conclusive judicial determination of the status of LPOs under the McFadden Act. See *Independent Bankers Ass'n of Am. v. Heimann*, 627 F.2d 486 (D.C. Cir. 1980).

46. Eisenbeis, *Interstate Banking Federal Perspectives and Prospects*, in *BANK STRUCTURE AND COMPETITIONS* 174 (1981) (Federal Reserve Bank of Chicago).

47. 12 U.S.C. §§ 611-631 (1982).

48. 12 C.F.R. §§ 211.1-211.602 (1985).

49. 12 U.S.C. § 1842(d) (1982).

50. See, e.g., *South Dakota v. National Bank of South Dakota*, 219 F. Supp. 842 (D.S.D. 1963), *aff'd*, 335 F.2d 444 (8th Cir. 1964), *cert. denied*, 379 U.S. 970 (1964); *Leuthold v. Camp*, 273 F. Supp. 695 (D. Mont. 1967).

defies geographic boundaries."⁵¹ There are an estimated 100 interstate ATM systems.

Under a series of judicial decisions, an ATM is considered to be a McFadden Act "branch" of the bank which owns it.⁵² It was recently confirmed, however, that an ATM is not a branch of a bank which does not own the ATM, even if the bank's customers had access to the ATM.⁵³

f. calling programs

Through calling programs, larger banks provide loan and deposit services to businesses and institutions throughout the country. It is not possible to estimate the magnitude of business generated by calling officers. Nonetheless these programs, combined with loan production offices and telephonic and electronic communications, have established a truly national banking market for larger businesses and institutions.

g. retail solicitation programs

A number of larger banking organizations actively solicit retail loan and deposit business on an interstate basis. On the lending side, the principal focus is on credit cards. Interstate business is obtained by both direct mailings and purchases of credit card portfolios from other banks. Retail deposits are solicited through brokers. Such programs were made feasible by 1980 legislation which provided for the phasing out of interest rate ceilings on deposits of under \$100,000.⁵⁴

h. an analogy

The distortion created by this existing system of interstate banking can perhaps be best summarized by an analogy. Assume that grocery chains were only permitted to expand interstate under the same limitations as banking organizations. Grocery chains would then generally be prohibited from establishing new stores out-of-state and acquiring stores in other states. On an interstate basis, they would be limited to: (1) acquiring or establishing butcher shops, delicatessens, cheese stores, green

51. Frodin, *Electronics: The Key to Breaking the Interstate Banking Barrier*, BUS. REV., Sept.-Oct. 1982, 3, 11 (Federal Reserve Bank of Philadelphia).

52. *Independent Bankers Ass'n of Am. v. Smith*, 534 F.2d 921, 948 (D.C. Cir. 1976), cert. denied, 429 U.S. 862 (1981).

53. *Independent Bankers Ass'n of N.Y. State, Inc. v. Marine Midland Bank*, Nos. 84-7424 & 84-7448, slip op. at 2248 (2d Cir. Feb. 27, 1985).

54. *Depository Institutions Deregulation and Monetary Control Act of 1980*, Pub. L. No. 96-221, tit. II & III, 94 Stat. 132 (1980) (codified in scattered sections of 12 U.S.C.).

grocers and bakeries (the equivalent of the section 4(c)(8) laundry list); (2) acquiring or establishing stores which sold only ethnic foods, such as Mexican, Chinese, etc. (the equivalent of Edge corporations); (3) selling to large purchasers such as restaurants, schools and hospitals (the equivalent of national wholesale banking); (4) acquiring large grocery chains which had failed (the equivalent of Title I of Garn-St Germain); and (5) for a limited number of grocery chains, acquiring or establishing additional stores in states where they had been in operation before the restrictive legislation was enacted (the equivalent of the Douglas Amendment grandfather provisions).

B. *The Issue of Concentration of Banking Services*

The legislative history of the McFadden Act and the Douglas Amendment establishes that the primary objective of these congressional restrictions was the prevention of excessive concentration of banking services.⁵⁵ The continued relevance of this concern, however, is open to serious question.

1. Absence of existing concentration

Even if the banking organizations alone are considered, the banking industry is remarkably unconcentrated. Based on domestic deposits, the largest bank has only a 3.7% national market share and the ten largest banks have a 14.8% collective national market share. Furthermore, during the past fifty years, concentration in the banking industry has been declining. In 1935, the largest banking organization held approximately 4.3% of domestic deposits and the ten largest banking organizations held approximately 24% of domestic deposits.⁵⁶

These statistics, however, vastly exaggerate the extent of concentration in the banking services industry. As has been increasingly recognized by bank regulators, economists and commentators, banking organizations confront vigorous competition from other financial services companies for every aspect of the banking business.⁵⁷

For example, thrift institutions (savings and loan associations, savings banks and credit unions) have achieved a virtual powers parity with

55. See PRESIDENT'S REPORT, *supra* note 28, at 1.

56. Statistics compiled from FEDERAL DEPOSIT INSURANCE CORPORATION, SUMMARY OF ACCOUNTS AND DEPOSITS IN ALL COMMERCIAL BANKS (1935 & 1983). See generally Glassman & Eisenbeis, *Bank Holding Companies and Concentration of Banking Financial Resources*, in THE BANK HOLDING COMPANY MOVEMENT TO 1978: A COMPENDIUM (1978).

57. PRESIDENT'S REPORT, *supra* note 28, at 2; National City Corp., 70 Fed. Res. Bull. 743 (1984); Office of the Comptroller of the Currency, Decision on the Application of Peoples National Bank of Central Pennsylvania (Nov. 5, 1984).

banks as a result of federal and state legislation.⁵⁸ Thrift institutions hold deposits equal to 50% of commercial bank domestic deposits.

Money market funds, spawned by the high interest rate environment in the late 1970's and the then-existing restrictions on interest rates payable on bank deposit accounts, also compete. These funds, which offer a meaningful alternative to bank deposit accounts, hold funds equal to 14% of commercial bank domestic deposits.

Another competing service, commercial paper, has become the primary source of short-term funding for major corporations. Commercial paper represents 49% of bank commercial and industrial loans.

A number of financial conglomerates, including Sears Roebuck, American Express and Merrill Lynch, offer virtually a full range of banking services on a national basis. It is estimated that each of these companies generates revenues from banking services which would rank it among the fifteen largest banks. These companies have been described as having a "potential impact . . . on the financial markets [which] is enormous."⁵⁹

A number of the nation's industrial and retail companies offers loans and other financial services through finance subsidiaries or directly. These include General Motors, Ford Motor, General Electric, J.C. Penney and K-Mart. Each of the first three companies has more loans than the sixteenth largest banking organization; the first two would rank second and eleventh, respectively.

Other competitors for bank services include: insurance companies for bank loans and certain deposit services; broker-dealer cash management accounts for bank deposits; and various investment advisors and mutual funds for bank trust services.

If banking organizations have been able to retain 50% of the market for bank services, a percentage which appears high,⁶⁰ then the largest banking organization would have only a 1.85% national market share and the ten largest only a collective 7.4% share. Such concentration is far less than that held by other retail organizations. The largest broker has an estimated 15% market share (based on commissions for listed

58. See Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 103(b)(1)(A), 94 Stat. 132, 133 (1980) (codified in scattered sections of 12 U.S.C.); Thrift Institutions Restructuring Act, Pub. L. No. 97-320, 96 Stat. 1496 (codified in scattered sections of 12 U.S.C.); N.C. GEN. STAT. § 54B-195 (1982).

59. Gart, *The Financial Conglomerates*, ECON. REV., May 1983, at 21 (Federal Reserve Bank of Atlanta).

60. A recent Administration study found that banking organizations hold only 35% of private financial assets. VICE PRESIDENT OF THE UNITED STATES, BLUEPRINT FOR REFORM: THE REPORT OF THE TASK GROUP ON REGULATION OF FINANCIAL SERVICES 17 (1984).

securities); the ten largest have over a 50% market share.⁶¹ The largest life insurance company has an estimated 8% market share (based on premiums); the ten largest have a 32% market share.⁶² The largest grocery chain has an estimated 18% share (based on sales); the ten largest have a 77% market share.⁶³

The competition for banking services from companies other than banks did not exist, and was not anticipated, when Congress adopted the basic federal limitations on interstate banking. Its existence today calls into serious question the validity of any continuing concern about excessive concentration.

2. Absence of potential for concentration

Not only is there an absence of existing concentration in the banking industry, but the potential for excessive concentration would not exist if the interstate barriers were lowered. A combination of economic, regulatory and legal factors precludes massive acquisition programs by the nation's largest banks. It is likely that most interstate combinations will involve low premium combinations between regional banking organizations of roughly similar size and relatively modest acquisition programs by the nation's largest banks.

At the risk of generalization, business combinations in the banking industry can be divided into two general categories. First, there are acquisitions in which the acquiring company pays a substantial market premium for the acquired company, and the acquired company's management thereafter plays little or no role in the direction of the combined entity. Second, there are transactions in which the shareholders of neither company receive a substantial market premium, and the managements of both companies play a role in the direction of the combined entity.⁶⁴ Although not technically accurate, the first category will be referred to as acquisitions, and the second as mergers.

It is unlikely that the nation's largest banking organization would enter into mergers with smaller banks. As a matter of their own corporate culture, they are unlikely to accept the management of a smaller

61. Based on figures from LIPPER ANALYTICAL SERVICES, INC., LIPPER-SECURITY INDUSTRIES FINANCIAL ANALYSIS SERVICES (1984) and annual reports.

62. A.M. BEST CO., BEST'S INSURANCE MANAGEMENT REPORTS—LIFE/HEALTH (79th ed. 1984).

63. Based on statistics from the Food Marketing Institute.

64. There are, of course, a wide variety of combination structures falling between these two extremes.

bank in a co-equal role. Moreover, smaller banks are likely to demand a substantial market premium.

At the same time, there are significant limitations on the capacity of the nation's largest banking organizations to acquire other banks. A key limitation is the Federal Reserve Board's capital requirement for acquisitions. As a general policy, an acquiring bank holding company must have tangible primary capital, on a *pro forma* basis for the acquisition, of at least 5.5%.⁶⁵ Under this guideline, most of the nation's largest bank holding companies would be precluded from large acquisition programs, as a result of purchase accounting, if the consideration included cash or debt and therefore resulted in intangible assets such as good will.⁶⁶

The incurrence of good will could be avoided, and capital ratios improved, if acquisitions were made for stock. However, a second limitation on the nation's largest banks—market conditions—makes large stock acquisitions impracticable. The stocks of most money center banks trade at a discount from book value and at a multiplier of about six times earnings.⁶⁷ In contrast, the stocks of profitable regional bank holding companies trade at a substantial premium to book value and at a multiplier of eight to ten times earnings.⁶⁸ As a result, the money center banks could not afford to make a number of large stock acquisitions at premiums consistent with those being paid in the industry without suffering an unacceptable level of dilution.

Moreover, this market disparity is so substantial that money center banks could not, in a number of cases, acquire even a single regional bank. For example, Chase Manhattan is approximately twelve times larger than Wachovia Corporation in terms of assets.⁶⁹ Nonetheless, if Chase sought to "acquire" Wachovia for stock and paid a 75% premium over Wachovia's current market price, Wachovia's shareholders would own over 50% of the combined company.

The antitrust laws represent perhaps the most important factor preventing excessive concentration in the event of liberalized interstate banking. This factor was not present, or at least not perceived to be present, when Congress enacted the McFadden Act and Douglas Amendment. Prior to the *United States v. Philadelphia National Bank*⁷⁰ case in

65. National City Corp., 70 Fed. Res. Bull. 743 (1984).

66. See generally FINANCIAL ACCOUNTING STANDARDS BOARD, ORIGINAL PRONOUNCEMENTS, APB 16, at ¶ 87 (Aug. 1970).

67. *Financial Services Stocks*, Am. Banker, Mar. 5, 1985, at 14, col. 1.

68. *Id.* at 14, col. 1-3.

69. Based on various public filings by Wachovia and Chase Manhattan and closing stock prices on April 19, 1985, as reported in the Wall Street J., Apr. 22, 1985, § 2, at 38, col. 2, 8.

70. 374 U.S. 321 (1963).

1963, it was widely assumed that the antitrust laws did not apply to bank mergers. Efforts by the Federal Reserve Board to challenge the interstate expansion by Transamerica under section 7 of the Clayton Act⁷¹ had proved unsuccessful.⁷² As a result, Congress may have viewed geographic restrictions as the only effective method of preventing excessive concentration in the banking industry.⁷³

It could be argued that Congress had available another effective method of halting bank expansion—incorporating the antitrust standards into federal legislation governing bank acquisitions. Such an approach had not been adopted in 1927 or 1933, but it was adopted in section 3(a) of the Bank Holding Company Act.⁷⁴

The legislative history of the Bank Holding Company Act, however, shows that the geographic restrictions of the Douglas Amendment were still related to a concern about excessive concentration. Although the section 3(a) antitrust standards were included in all versions of the legislation, Congress was evidently concerned that this was not sufficient. There were repeated references to the dominance of Transamerica in the West and First Bank System and Northwest Bancorporation in the upper Midwest.⁷⁵

In point of fact, Congress' concern may well have been appropriate. Interstate acquisitions would normally be subject to challenge on anti-trust grounds only under a potential competition doctrine. There was of course no precedent on how this doctrine would have been applied to banks. Moreover, at the time the Douglas Amendment was enacted, the very concept of potential competition had not yet been judicially accepted.⁷⁶

Although no bank acquisition has yet been barred as a result of a potential competition challenge, the application of this doctrine to the banking industry is undeniable.⁷⁷ Furthermore, in the two most recent decisions relating to bank potential competition, the courts articulated standards and procedures for determining whether and how this doctrine

71. 15 U.S.C. § 18 (1982).

72. See, e.g., *Transamerica Corp. v. Board of Governors*, 206 F.2d 163 (3d Cir.), cert. denied, 346 U.S. 901 (1953).

73. Senator Glass attempted, at one point, to argue that the regulatory approval process for bank branches would check excessive concentration, but this view was not endorsed by others. 75 CONG. REC. 9898 (1932) (statement of Sen. Glass).

74. 12 U.S.C. § 1842(a) (1982).

75. See 102 CONG. REC. 6858 (1956) (statement of Sen. Douglas).

76. Cf. *United States v. Penn-Olin Chemical Co.*, 378 U.S. 158 (1964).

77. *United States v. Marine Bancorporation*, 418 U.S. 602 (1974).

should be invoked.⁷⁸

Accordingly, the antitrust laws, as now developed and explicated, should serve to check the undue concentration which the geographic barriers were designed to prevent. If there remains a concern that antitrust laws are not sufficient to accomplish this purpose, it would be possible to deal with this concern by a less draconian and more direct method than an absolute ban on interstate banking. For example, there could be a prohibition on acquisitions if the acquiring bank holding company's domestic deposits exceeded a designated percentage of total domestic deposits. On the state level, there are already limitations in a number of states on the aggregate percentage of state deposits which can be controlled by a single banking organization.⁷⁹ As one senior Federal Reserve official has written: "Banking is not now highly concentrated, so there is time to explore alternatives for policies governing [interstate] mergers."⁸⁰

As late as 1956, congressional concern over potential domination by the money center banks was largely untested. The limited available evidence suggested that such a danger might exist. Multi-state bank holding companies such as Transamerica, Northwest and First Bank System had assumed major positions in several states. These states were, however, for the most part small rural states, and the large market shares of these out-of-state holding companies were frequently due to the financial collapse of independent banks prior to meaningful out-of-state entry.⁸¹

Since passage of the Bank Holding Company Act, New York has provided an ideal laboratory for testing congressional concern over money center bank domination. In 1960, New York enacted legislation which paved the way for statewide banking.⁸² Five of the nation's seven largest banking organizations are in New York;⁸³ if interstate banking would produce excessive concentration, it should have occurred in New York.

In point of fact, the passage of statewide banking legislation in New York did not result in statewide domination by the money center banks.

78. *Republic of Texas Corp. v. Board of Governors*, 649 F.2d 1026 (5th Cir. 1981); *Mercantile Texas Corp. v. Board of Governors*, 638 F.2d 1255 (5th Cir. 1981).

79. See, e.g., N.J. STAT. ANN. § 17:9A-345 (West 1984).

80. Billington, *Bank Deregulation and Concentration—What Policy for Mergers?*, ECON. REV., Nov. 1983, at 6 (Federal Reserve Bank of Kansas City).

81. See *Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs on S. 880, S. 2350, H.R. 6227*, 84th Cong., 1st Sess. 311 (statement of J. Cameron Thompson), 381-83 (statement of Frank N. Belgrano, Jr.) (1955) [hereinafter cited as *BHC Act Hearings*].

82. Omnibus Banking Act, 1960 N.Y. Laws ch. 237.

83. *Am. Banker*, Jan. 31, 1985, at 3, col. 2.

During the 1960-1983 period, the total market share held by the three largest banking organizations actually declined from 40% to 39%.⁸⁴ In the same period, the larger upstate banking organizations and smaller New York City banks were able to increase their market share. During this period Key Banks' statewide market share increased from 0.4% to 1.3%, Norstar's market share from 0.8% to 1.7%, and Bank of New York's market share from 1.4% to 3.6%.⁸⁵

If the major money center banks did not come to dominate banking in New York, it is highly unlikely that they would achieve dominance on a national scale. New York is a considerably smaller unit than the nation, in terms of both population and geography. Moreover, the New York City banks had long experience in and substantial familiarity with their own state.

The result in New York is consistent with numerous studies which indicate that small banks can compete effectively with larger bank entrants.⁸⁶ In large measure, this occurs because economies of scale do not appear to be present above a very small size bank.⁸⁷

Additional empirical evidence on the pattern of business combinations in an interstate environment is provided by the experience in the two state-created interstate banking regions.⁸⁸ Purportedly acting under the state authorization clause of the Douglas Amendment, three states in New England and five states in the Southeast have established regions for interstate expansion.⁸⁹

In New England, the first announced interstate transaction involved the second and sixth largest organizations (CBT and Bank of New England Corporation) and a no-premium merger.⁹⁰ The dominant banking organization in New England, Bank of Boston, has agreed to make two acquisitions, but they involve only the tenth and twelfth largest organiza-

84. Federal Reserve Board, Call Data for All Commercial Banks in the United States (July 30, 1984); FEDERAL RESERVE BANK OF NEW YORK, BANKING STUDIES DEPARTMENT.

85. FEDERAL RESERVE BANK OF NEW YORK, BANKING STUDIES DEPARTMENT.

86. See S. RHOADES, THE IMPLICATIONS FOR BANK MERGER POLICY OF FINANCIAL DEREGULATION, INTERSTATE BANKING, AND FINANCIAL SUPERMARKETS, STAFF STUDIES 137 (1984) (Federal Reserve Board); E. KOHN, THE FUTURE OF SMALL BANKS (Dec. 1966) (New York State Banking Dept.).

87. Benston, Hanweck & Humphrey, *Scale Economies in Banking: A Restructuring and Reassessment*, 14 J. MONEY, CREDIT & BANKING 435, 452 (1982).

88. There has not, however, yet been sufficient experience to make a definitive assessment.

89. The constitutionality of these state statutes has been challenged. *Northeast Bancorp v. Board of Governors*, 740 F.2d 203 (2d Cir. 1984), cert. granted, 105 S. Ct. 776 (1985).

90. See Carson, *Conn., Mass. Banks Announce Big Interstate Merger Plan*, Am. Banker, June 14, 1983, at 1, col. 3.

tions (RIHT and Colonial).⁹¹ The first interstate transaction in the Southeast involves a no-premium merger between the fourth and ninth largest banking organizations (Sun Banks and Trust Company of Georgia).

3. Increased concentration created by the present system

The argument against continuation of interstate restrictions as a check on excessive concentration goes well beyond the conclusion that these restrictions are no longer necessary. Indeed, it appears that the present structure fosters rather than prevents concentration. This occurs at both the state and the national levels.

When Congress earlier debated the interstate issue, banking in most states was unconcentrated. Only ten states then permitted statewide branching, and multibank holding companies within a single state were relatively rare.⁹²

In the last twenty-five years, this situation has changed drastically, due to both legislative and regulatory developments. On the legislative side, there are today only a handful of states which do not permit statewide banking (in branch or holding company form or both). On the regulatory side, there has been substantial relaxation in the competitive standards applied by the federal banking agencies, particularly the Federal Reserve Board.⁹³ In the past three years, the federal bank regulatory agencies have approved, and the Justice Department has not challenged, mergers involving two of the five largest banking organizations in New Jersey, Connecticut, Pennsylvania, Virginia, South Carolina, Florida, Kentucky, Ohio, Illinois, Oklahoma and Nebraska.⁹⁴ Between 1966 and

91. See Fraust, *Banks Stake Out an Interstate Future*, Am. Banker, Apr. 2, 1984, at 1, col. 2.

92. See 75 CONG. REC. 9986 (1932). Nonetheless, as early as 1932, Senator Glass recognized that the continuation of geographic restrictions created monopolistic tendencies in local markets. 75 CONG. REC. 9892 (1932); 76 CONG. REC. 1405 (1933).

93. This change appears due in part to the Justice Department's more lenient guidelines on horizontal mergers, Merger Guidelines of Department of Justice—1982, 2 TRADE REG. REP. (CCH) ¶ 4500 (1984), and, of even more importance, to a recognition that thrift institutions compete with commercial banks. National City Corp., 70 Fed. Res. Bull. 743 (1984).

94. FIRST JERSEY NAT'L BANK, 3 COMPTROLLER CURRENCY Q.J. No. 4, at 83 (1984); CONN. BANK & TRUST CO., 2 COMPTROLLER CURRENCY Q.J. No. 2, at 66 (1982); VA. NAT'L BANK, 3 COMPTROLLER CURRENCY Q.J. No. 1, at 161 (1983); LIBERTY NAT'L BANK, 2 COMPTROLLER CURRENCY Q.J. No. 1 at 120 (1983); Office of the Comptroller of the Currency, Decision on the Application of First Nat'l Bank of S.C. (1984); National City Corp., 70 Fed. Res. Bull. 743 (1984); First Chicago Corp., 70 Fed. Res. Bull. 351 (1984); Banks of Mid-Am., Inc., 70 Fed. Res. Bull. 460 (1984); Omaha Nat'l Corp., 70 Fed. Res. Bull. 447 (1984); Sun Banks, Inc., 69 Fed. Res. Bull. 939 (1983); Mellon Nat'l Corp. 69 Fed. Res. Bull. 302 (1983).

1982, the three largest banks in Florida acquired a total of 124 banks, and four large Texas bank holding companies acquired a total of 153 banks.⁹⁵

As a result, concentration has increased dramatically in many states. For example, in the last five years the market share of the three largest banks has increased from 13% to 32% in New Jersey and from 8% to 38% in Florida.⁹⁶

Only the advent of liberalized interstate banking is likely to check this pronounced trend toward increased concentration at the state level. Interstate banking would relieve the pressure for intrastate mergers by providing alternative expansion outlets. It would also introduce new competitors into the state markets. Pure logic dictates that states which are attractive for entry will have additional competitors if existing barriers to entry are removed.

On a national level, Congress in 1927, 1932-33 and 1956 repeatedly expressed its concern about the domination of the banking industry by a small number of money center banks.⁹⁷ Yet, it is the present interstate system which is responsible for the small number of money center banks with a national presence. As discussed above, under the present system there is interstate banking, but it can be accomplished only in an abnormal manner. This system provides a substantial advantage to the largest and most financially powerful banking organizations; only they can afford the inherent inefficiencies and risks. A more rational system of interstate banking, permitting normal merger and acquisition activity, would increase the potential for multiple banks with a national presence.

The nation's largest bank holding companies have taken advantage of the present system to assume an increasingly national presence. Citicorp, the largest bank holding company, has utilized the Garn-St Germain provisions (and the prior similar policy of the Federal Reserve Board) to acquire large troubled retail depository institutions in the key markets of Illinois, Florida and California.⁹⁸ Citicorp's Edge corporation has branches in twelve states. Its consumer finance and mortgage

95. S. RHOADES, *MERGERS AND ACQUISITIONS BY COMMERCIAL BANKS, 1960-83*, Staff Studies No. 142 (1984) (Federal Reserve Board).

96. These levels far exceed the levels of national concentration which are likely to occur if interstate banking is liberalized. For example, when BankAmerica acquired the largest bank in Washington and the 18th largest bank in the country, SeaFirst, its national market share increased by only 0.6% to 3.7%. BankAmerica Corp., 69 Fed. Res. Bull. 568 (1983). If BankAmerica were to acquire the 25th, 35th, 45th, 55th and 65th largest banking organizations, a practical impossibility, its national market share would increase to only 5.5%.

97. S. REP. NO. 584, Part II, 72d Cong., 1st Sess. 4 (1932).

98. Citicorp., 70 Fed. Res. Bull. 149, 157 (1984), 69 Fed. Res. Bull. 554 (1983).

subsidiaries have hundreds of interstate offices. It has LPOs in virtually every major city.

A small number of other giant banks have also been able to engage in major interstate expansion under the present system. BankAmerica, the second largest bank holding company, was able to acquire the dominant bank in Washington.⁹⁹ BankAmerica already has a national consumer finance chain with 195 offices in 43 states. Its Edge corporation subsidiary has branches in ten states and would rank as the country's sixtieth largest bank.¹⁰⁰ Manufacturers Hanover, the fourth largest bank holding company, recently achieved an immediate national presence through the acquisition of CIT's 313 offices in 44 states.¹⁰¹

The impact of this expansion-through-exception process is illustrated by a statistical comparison. In 1970, the largest banking organization was \$17 billion larger than the fifth and \$21 billion larger than the tenth.¹⁰² Today, the comparable figures are \$86 billion and \$111 billion.¹⁰³

Moreover, these statistics may actually understate the increasing disparity. Citibank has a substantial retail banking presence in four of the nation's major banking markets. No other bank has such a presence outside its home market. Citibank has approximately 800 out-of-state offices, approximately 200 of which are deposit-taking (based on total Citicorp/Citibank/COIC domestic offices as of December 31, 1984); BankAmerica has 415 out-of-state offices, 195 of which are deposit-taking.¹⁰⁴

Analysis suggests that the present system has created this disparity and will continue to increase it. Banks other than Citicorp would obviously want to enter such markets as California and Florida. They lack, however, the financial resources to accept the losses involved in restoring a failing savings and loan association to profitability. They also lack the managerial resources required to undertake such a task. Manufacturers Hanover just barely had sufficient size to acquire CIT.¹⁰⁵ For a smaller bank holding company, it would have been out of the question. A major bank holding company, other than BankAmerica, expressed an interest in acquiring SeaFirst. It was told by the Federal Reserve that

99. See BankAmerica Corp., 69 Fed. Res. Bull. 568, 570, 571 (1983).

100. Am. Banker, Oct. 24, 1984, at 28.

101. Manufacturers Hanover Corp., 70 Fed. Res. Bull. 452, 452-53 (1984).

102. FEDERAL RESERVE BANK OF NEW YORK, BANKING STUDIES DEPARTMENT.

103. Am. Banker, Jan. 31, 1985, at 3, col. 2.

104. Interview with Rich Beede, Bank of America Public Relations Department (Jan. 29, 1985).

105. Manufacturers Hanover Corp., 70 Fed. Res. Bull. at 453-54.

BankAmerica was a preferable acquiror because its substantially greater size would enable it to endure unexpected losses.

Only through a more rational interstate banking structure will it be possible to reverse this trend whereby national banking is the province of only a handful of the very largest banking organizations. If banking organizations could engage in normal interstate merger and acquisition activities, there would be the potential for a number of other national competitors. It is widely accepted that there ultimately will be full interstate banking. Unless this occurs in the relatively near future, the largest banking organizations will have established such a commanding lead under the present system that other banking organizations will be unable to become effective nationwide competitors.

C. *The Issue of Bank Safety and Soundness*

In 1984, the banking industry experienced its most serious financial problems since the depths of the Great Depression. Seventy-nine banks failed, the most since 1938. For the first time in this century, one of the nation's ten largest banks, Continental Illinois, would have failed but for massive government intervention. The FDIC's list of problem banks skyrocketed to 817. All ten of the largest quarterly losses ever posted by United States banks occurred in 1983 and 1984.

In view of these developments, the potential impact of interstate banking on bank safety and soundness must be analyzed both in terms of individual banks and the banking system as a whole. If there is a meaningful possibility that interstate banking would enhance bank safety and soundness, this is a powerful, if not irrefutable, argument for interstate banking.

This analysis properly begins with a historical perspective. Twice, in the McFadden Act in 1933 and in Garn-St Germain in 1982, Congress modestly reduced the restrictions on bank geographic expansion. As discussed above, in both cases the motivation was bank safety and soundness. Thus, Congress is on record as being willing to liberalize interstate banking limitations to promote bank stability. Moreover, the largest existing multistate bank holding companies were established, in substantial part, in response to the banking crisis in the late 1920's to early 1930's.¹⁰⁶

In more recent times, the largest and most spectacular collapse of a bank was that of Continental Illinois in 1984. Commentators have attributed the collapse to Continental's lack of liquidity, the poor quality of

106. *BHC Act Hearings*, *supra* note 81, at 311, 318-20.

its loan portfolio and lack of diversification.¹⁰⁷

All of these problems could be attributed to legal restrictions on geographic expansion. With respect to liquidity, Illinois' unit banking provision effectively precluded Continental from access to "core" deposits. Although automated teller machines and other technological advances have diminished the importance of proximity to retail deposit taking, numerous studies have demonstrated the importance of convenience in obtaining core deposits.¹⁰⁸ Continental's single office in the Loop could not provide this convenience.¹⁰⁹

A closely related advantage of an expanded geographic presence would have been the opportunity for Continental to establish a meaningful retail banking business.¹¹⁰ Such a business may have provided an earnings cushion to shelter Continental's mistakes in commercial lending. It may also have provided an opportunity for Continental to have satisfied its desire for growth without undertaking the more risky aspects of its commercial loan expansion.

At the heart of Continental's problems was the poor quality of its loan portfolio. The most serious problems resulted from participations in loans made by Penn Square National Bank, large loans to secondary participants in the oil and gas industry and foreign loans to marginal private credits. The one common denominator of these loans, other than their poor quality, was their distance from Continental's home office.

There is not necessarily a correlation between the distance of a borrower from the home office and the soundness of the loan. Nonetheless, it is likely that a bank will be less familiar with a borrower which is at a distance, and less familiarity inherently involves greater risk. The bank will be less knowledgeable about the specific borrower and the area's economy. The bank will be less capable of policing the loan on an ongoing basis.

It is of course possible that Continental would have made its poor loans irrespective of its ability to expand geographically. Yet it is likely that Continental would have had fewer problems if it had been able to

107. See *Federal Reserve's Second Monetary Policy Report for 1984: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 2d Sess. 14-17 (1984) (statement of Paul A. Volcker, Chairman, Federal Reserve Board).

108. See Riggall, *A New Study: How Newcomers Select Banks*, A.B.A. BANKING J., July 1980, at 92.

109. The importance of access to core deposits should not, however, be exaggerated. Although Continental was an aggravated case, the relative importance of core deposits at many money center banks has been steadily declining.

110. See Sinkey, *The Characteristics of Large Problem and Failed Banks* 11 (Aug. 29-30, 1984) (unpublished manuscript) (delivered at Bank Administration Institute program).

purchase a bank in Oklahoma or Texas, as opposed to relying on participations purchased from Penn Square. Stated differently, Continental would have been in a better position to achieve a quality loan portfolio if its growth plans could have been channeled into acquisitions of healthy banks rather than into loans far removed from its home base.

Although a concentration of lending in a bank's natural market area would improve credit review and control, concentration could also create serious problems if the natural market does not have a sufficiently diverse economic base. The banking industry in Texas provides a case in point.

During the 1970's and the early 1980's, banks in Texas were, as a whole, the strongest in the country. The Texas economy is largely based on the oil and gas industry, and as this industry expanded rapidly after the so-called oil shocks, so did bank profitability.

When, however, oil prices collapsed in 1983 and 1984, the profitability of many Texas banks plunged as precipitously. The First National Bank of Midland, which had almost one billion dollars in deposits, failed.¹¹¹ InterFirst, the largest Texas banking organization, lost \$249 million in the third quarter of 1983.¹¹² Quarterly losses were also incurred by three other large Texas banking organizations.¹¹³

Such losses were not surprising because the loans of these Texas banking organizations were heavily concentrated in Texas, and concentration in Texas meant concentration on oil and gas loans. A number of major Texas banking organizations had oil and gas loans which represented 20% or more of their total loan portfolios.¹¹⁴ Moreover, the decline of the energy industry had a ripple effect throughout the entire Texas economy. The real estate industry was particularly hard hit as development plans and prices declined. The Texas banks were also large lenders to the Texas real estate industry.

The decline in the oil and gas industry would have adversely affected Texas-based banking organizations irrespective of whether geographic restrictions had previously been liberalized. It is likely, however, that this negative impact would have been ameliorated if Texas banking organizations had been able to expand into their natural market regions in the Southeast.

During the same period in which the Texas economy went into a tailspin, the economies in states such as Georgia, Florida and the Caroli-

111. Fraust, *Texas Bank Stocks Drop After Weekend's Ill News*, Am. Banker, Oct. 11, 1983, at 2, col. 1.

112. N.Y. Times, Oct. 13, 1984, § 1, at 37.

113. N.Y. Times, Oct. 29, 1983, § 1, at 41.

114. Review of various annual reports.

nas were booming. If Texas banking organizations had been permitted to expand into such states, it is likely that the relative proportion of Texas oil and gas loans would have been reduced. Not only would the losses in Texas-based lending have been spread over a wider base, but the profits generated in more profitable economies could have cushioned the losses suffered in Texas.

An even more serious banking problem may exist today in such agricultural states as Kansas, Nebraska and Iowa. The economies of these states are heavily dependent on agriculture, and the decline in prices for farm products and farm land has created an economic tailspin.

The consequences have been felt directly by the banks in these states. Because the loans of the banks are concentrated in their home states, the problems in agriculture have translated into problems in the banks. In 1984, there were a total of fifteen bank failures in Iowa, Kansas and Nebraska, as compared to a total of eleven failures in the ten years between 1970 and 1980.¹¹⁵ Many of the larger banks in these three states have experienced a serious downturn in their earnings or even losses.

The basic concept here is simple and universally accepted. Diversification reduces risk. "To control [credit] risk, the *raison d'être* of portfolio theory, *diversification*, should be followed. Continental, Midland, Penn Square, and other energy lenders violated this fundamental principle."¹¹⁶ Because the vast majority of banking institutions are limited to a single state, however, their ability to achieve diversification is largely a function of their state's economic base. If the state's economy is based on a single industry, the bank's loans and its ultimate profitability will also be based on that industry.

This problem was recognized as early as 1932 by Senator Glass in urging expanded branching authority.¹¹⁷ He stressed that in one-crop states or one-mineral states banks were particularly vulnerable to downturns in the local economy. "Two fundamental causes are at the root of the small bank failures—lack of diversity and necessarily lack of earning power."¹¹⁸

The restrictions on interstate banking are inevitably restrictions on diversification. These restrictions therefore create greater risk.

115. See *Despite Failures, Tennessee Banking System Called Healthy*, Am. Banker, Feb. 13, 1985, at 12, col. 1.

116. Sinkey, *supra* note 110, at 6. See also 12 U.S.C. § 84 (1982); 12 C.F.R. § 31.2(b) (1984).

117. 75 CONG. REC. 9896 (1932) (statement of Sen. Glass).

118. *Id.*

Title I of Garn-St Germain illustrates one further advantage of increased liberalization of interstate banking. The ability of bank holding companies to cross state lines could reduce the potential for bank failures. Strong out-of-state banks, not subject to the vagaries of the local economy, would be able to acquire financially troubled banks. As discussed above, it was for this very reason, albeit on an in-state basis, that the federal branching restrictions were liberalized in 1933.¹¹⁹

It is nonetheless indisputable that Garn-St Germain has not served to avert bank failures. There have been no failing bank acquisitions under Garn-St Germain.

The reasons for this ineffectiveness are complex, and reflect in part the limitations contained in the statute.¹²⁰ This ineffectiveness, however, can be eliminated only by a general liberalization of interstate banking, and not by merely tinkering with Garn-St Germain.

An example of the need for more fundamental reform is illustrated by the failure of First National Bank of Midland. Despite the economic problems in the oil and gas industry, Texas is still widely regarded as a desirable market.¹²¹ Yet, when Midland failed, there was no serious out-of-state bidder. This was undoubtedly because an out-of-state buyer of Midland would have been confined to a single office in Midland as a result of Texas' unit banking statute. Although Texas bank holding companies can expand throughout the state through a multi-bank holding company structure, Garn-St Germain would not have provided a similar opportunity for an out-of-state acquirer.

Moreover, the vast majority of banks experiencing serious financial difficulty are relatively small. Garn-St Germain presently limits interstate acquisitions to banks with at least \$500 million in assets. Even if this statutory size limitation were removed, a practical impediment to acquisition would continue to exist.

As a general rule, out-of-state bank holding companies would have little or no interest in entering a state solely through the acquisition of small financially troubled banks. If, however, out-of-state banking insti-

119. *Id.*

120. For example, the requirement that the acquired bank have actually failed discourages acquisitions. With rare exception, a bank does not fail overnight. The deterioration occurs over a period of time, during which the value of the franchise diminishes. Major depositors and borrowers leave and key management departs. The acquirer of a failed bank, therefore, would frequently acquire only a shell.

121. There have been 33 applications by out-of-state bank holding companies to form non-bank banks in Texas, more than any other state except Florida. Office of the Comptroller of the Currency, Summary of Non-Bank Bank Applications Filed with the OCC (Jan. 22, 1985).

tutions could acquire healthy larger banks within the state, additional acquisitions of financially troubled small banks might make sense.

The importance of out-of-state bank holding companies as potential acquirors is particularly important in those one-industry states where a decline in that industry adversely affects the entire banking system. In the agricultural and energy states, the largest bank holding companies remain solvent, but most are experiencing substantial loan quality problems. They are in no position to take on the problems of smaller, more seriously troubled banks.

The recent, and as of yet untested, deregulation of deposit interest rates creates the potential for additional pressure on bank stability. The Depository Institutions Deregulation and Monetary Control Act of 1980¹²² has transformed a substantial portion of bank funding from a low, fixed cost or no cost basis to a market variable rate.¹²³

The potential negative impact of this legislation has been mitigated by the absence of high interest rates since the deregulation occurred. If rates increased to the 15-20% level of the 1979-1980 period, the impact of deposit deregulation could be severe. A number of banks may not have been able to achieve an asset sensitivity which conforms to their liability sensitivity. Moreover, even if that asset sensitivity has been achieved in theory, as a practical matter many borrowers may be unable to survive if the rates on their loans climbed to such high levels. In such a scenario, it would be essential that the healthier banks be in a position to deal adequately with the problem.

D. Other Issues

1. The issue of protecting local banks from competition

Closely related to the congressional concern over concentration was an intention to protect local banks from competition. A number of the developments previously discussed, however, have substantially vitiated the capacity of the McFadden Act and Douglas Amendment to accomplish this objective. Local banks now face competition from the section 4(c)(8) subsidiaries and other interstate operations of out-of-state bank holding companies. Competition also comes from the wide variety of financial concerns that are not subject to geographic limitations.

Today, even retail customers are increasingly able to obtain financial

122. Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified in scattered sections of 12 U.S.C.).

123. This change has not significantly affected some of the money center banks due to their already heavy reliance on purchased funds.

services on a nationwide basis through credit card accounts, finance and mortgage companies, and money market and cash management accounts. Under these circumstances, congressional geographic limitations designed to protect local banks are increasingly counterproductive. As pointed out by perhaps the leading economist on the issue of interstate banking:

The real importance, however, of the money market mutual funds is that they have served to break down the dependence of the previously locally limited customers on local depository institutions Under such circumstances any benefits that might have previously accrued to in-state institutions from the prohibitions on interstate banking—by protecting markets from entry or the threat on entry from out-of-state banks—are completely dissipated. In fact, the restrictions now become binding and have the opposite effect by preventing in-state banks from operating or competing on the same geographic scope as the money market funds or the users of financial services.¹²⁴

2. The issue of competitive equality

A congressional objective in adopting the McFadden Act and the Douglas Amendment was competitive equality among banking institutions. In the McFadden Act, Congress was concerned that the branching powers of state banks and national banks remain equal.¹²⁵ With respect to the Douglas Amendment, Congress was concerned that large multi-state holding companies would enjoy a competitive advantage.¹²⁶

In 1933 and 1956, when there was only minimal interstate banking, restrictions on all interstate banking promoted competitive equality. At the present time, however, now that there is substantial interstate banking, these restrictions have the opposite effect. This is particularly the case where the system of interstate banking favors the very largest financial institutions.

As previously discussed, only a handful of large money center banks have been able to establish a major interstate presence. Their very size enables them to utilize the existing avenues for interstate banking, while the risks and inefficiencies involved preclude smaller organizations from following a similar course. Moreover, the banking industry as a whole is

124. Eisenbeis, *supra* note 46, at 175-76.

125. 68 CONG. REC. 2166 (1927) (statement of Rep. McFadden).

126. 102 CONG. REC. 6857 (1956) (statement of Sen. Douglas).

at a competitive disadvantage because many of its nonbank competitors are not subject to any geographic limitation.

The competitive disparity which the McFadden Act and Douglas Amendment sought to prevent is now the very product of their existence. Today, liberalization of these restrictions would best accomplish Congress' actual objective.

III. CONCLUSION

Proponents of continued restrictions on interstate banking must justify a system which is contrary to this nation's fundamental economic policy—freedom to compete. They must further justify a policy which is contrary to the basic concept of a single union for economic matters.

Congress, first in 1927-1933 and then in 1956, concluded that restrictions on interstate banking were necessary despite such conflicts. There have been, however, major changes in the ensuing years in the relevant economic, legal and technological factors, and the concerns which motivated Congress at an earlier time should therefore be reexamined. Upon analysis, Congress' principal concern—concentration of banking resources and the necessity of geographic restrictions to prevent it—no longer appears valid. Moreover, Congress' concerns about safety and soundness, which were responsible for the modest relaxation of geographic barriers in 1933 and 1982, support further liberalization.

In the most detailed governmental study of the interstate issue in recent years, an Administration task force urged liberalization of geographic restraints on interstate banking.¹²⁷ The task force charged that the existing system

perpetuates the existing discrimination against the retail customer, deprives the public of the benefits of increased competition, impedes the efficient allocation of resources, retards the development and application of new technologies, and restricts the ability of bank management to compete with other, non-bank financial institutions.¹²⁸

Liberalization of interstate banking would be justified if only a small part of this indictment were accurate.

127. PRESIDENT'S REPORT, *supra* note 28, at 2.

128. *Id.*

