REGULATIONS AFFECTING COMPETITION BETWEEN BANKS AND THRIFT INSTITUTIONS IN THE FIFTH DISTRICT

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Over the past several years readers of this *Review* have been exposed to a number of articles dealing with the concept of banking structure and, more specifically, with the structure of geographic banking markets in the Fifth Federal Reserve District. These articles are listed in the accompanying bibliography [3; 6; 8; 11]. The approach generally taken has been to examine banks as single product firms, with the institutional scope of competition limited to banks themselves. Until recently this has in fact been the standard approach to banking structure studies, not only in purely economic literature but also in court antitrust decisions involving banking competition.[1] For some purposes, however, banks can be thought of as multiproduct firms offering an array of distinct services, or as "financial department stores" [1, p. 362]. It has become increasingly evident that banks enter into direct competition with nonbank financial institutions for some of these products.

This article briefly reviews the concept of competition between banks and nonbank financial institutions. Its major purpose is to review and compare the regulations governing market entry and branching by banks and competing nonbank financial institutions (thrift institutions) in the Fifth District. This approach expands an earlier treatment of the subject that appeared in this *Review* [3].

Competition Between Banks and Thrifts Both commercial banks and thrift institutions offer a wide array of services. On what basis, then, can a determination be made as to the extent and degree of competition between these different types of financial intermediaries? In certain product lines, for example demand deposits, there is generally no overlap, and the question of competition is, therefore, moot.[2] In other product lines, however, there is a great deal of similarity between the offerings of banks and thrifts, and there is some reason to expect that competition may exist for these services. The primary area of overlap for banks and thrift institutions is in the increasingly important field of retail banking services. Although this is a broad field, most research has been centered on competition for retail savings deposits. A review of this particular product market is interesting for the insight it gives into the nature of and methods for determining competition.

An economic test of the degree of competition between organizations offering similar products would focus upon the degree of substitutability between the respective product offerings. In the case of savings deposits, the assets offered by commercial banks and thrift institutions would be considered good substitutes if an increase (decrease) in the rate of return on one produced a significant decrease (increase) in the amount held of the other. If a change in the rate of return paid on one resulted in a proportionate, but negative, change in the amount held of the other, the products could be considered identical. An independent relationship would exist if one asset failed to respond to changes in the interest rate paid on the other. There are, of course, several dimensions to the return from holding savings deposits. These include liquidity, safety, convenience, and explicit interest return. With respect to the first two, there is virtually no difference between bank and thrift institution savings deposits. Banks, however, due to their ability to offer a wider array of complimentary services, have an edge with respect to convenience. Thrift institutions, which can offer a ¼ percent differential over bank rates, have an edge with respect to interest return. These four factors all influence the degree to which bank and thrift deposits are substitutes.

A number of attempts have been made to measure the degree of substitutability between savings deposits offered by commercial banks and by

[1] In a seminal merger case involving two Philadelphia banks, the Supreme Court decided that competition should be examined solely in a banking institutions context. See United States v. Philadelphia National Bank, 83, S.Ct. 1715 (1963).

[2] Mutual savings banks in Maryland and several other states, however, have demand deposit powers.

thrift institutions. These attempts are conveniently summarized in a number of studies [9; 10; 12]. In one of these summaries, Gilbert and Murphy conclude that evidence from various time series and cross section studies shows that the savings deposit services offered by thrift institutions, specifically savings and loan associations and mutual savings banks, are close substitutes for commercial bank savings deposit services [9, pp. 10 and 17]. They also indicate that competition for savings deposits between these institutional types has increased in recent years [9, p. 14]. These conclusions suggest that, for completeness, any consideration of the structure of a market for savings deposits must include both commercial banks and thrift institutions.

There are other, although less well researched, product markets where the potential for competition between banks and thrift institutions is high. Due to recent regulatory changes, for example, banks are now allowed to offer business savings accounts up to $150,000 per customer, something that increases their potential for competition with thrift institutions.[3] Also, both banks and thrifts offer mortgage loans to consumers. In a related lending area, both make construction loans to builders. To a limited degree, they may also compete for consumer instalment loans. While the number of product markets where banks and thrift institutions offer similar services is limited, competition within any given market may be intense, just as it is in the case of savings deposits. Furthermore, with the nation's financial structure closer than ever to reforms that could dramatically alter the scope of activities for thrift institutions, the areas of competitive overlap could expand and intensify. These considerations argue for an approach to "banking structure" studies that takes into account interindustry competition.

The institutional structure of a given market strongly influences the degree of competition among financial intermediaries; this in turn influences the availability and cost of products or services in that market.[4] To a very important extent, the structure of financial markets is determined by regulations governing market entry and branching. These regulations may be explicitly based on statutory provisions or may be the result of discretionary action exercised by particular regulatory authorities. Furthermore, the regulations that apply to the various competing organizations may be different. Regulations may differ for the same types of institutions that have different charters (Federal or state), and they may differ among the several institutional types. Any given market will have a structure that is uniquely influenced, depending on the combination of regulations under which its participants operate. The rest of this article will focus on the regulatory makeup of Fifth District financial markets, with special attention given to the major financial intermediaries that operate in the District. In addition to commercial banks, these include savings and loan, or building and loan, associations (S&L's) and mutual savings banks (MSB's).[5]

Market Entry Entry into Fifth District markets by the financial intermediaries under consideration here is regulated by both the various states and by either the Comptroller of the Currency or the Federal Home Loan Bank Board for Federally chartered banks or S&L's, respectively. The only exception to the dual chartering system is the District of Columbia, the laws of which require all banks and S&L's to obtain the approval of the Federal regulatory agencies before they commence business.

The various chartering authorities consider a number of factors in reviewing applications to establish new financial organizations. These include needs of the community, quality of proposed management, impact upon existing institutions, and capital adequacy. Capital adequacy is the most objective of these factors and therefore is the easiest to measure. It also, of course, can be interpreted in different ways and can mean a great deal in terms of relative difficulty in gaining access to a market. Minimum capital requirements for market entry by banks are specified in the laws of each District state and in Federal law for national banks.[6] For S&L's, a distinction must be made between stock and mutual associations. Mutual charters are available in every District state and from the Federal Home Loan Bank Board. Virginia is the only state that grants stock charters for S&L's. The stock form

[3] *Effective November 10, 1975, the Board of Governors of the Federal Reserve System amended Regulations D and Q to permit profit-making organizations to hold savings accounts at member banks.* The FDIC took similar action regarding state nonmember banks. See "Amendments to Regulations D and Q," *Federal Reserve Bulletin,* (October 1975), p. 708.

[4] See reference [4] for a detailed discussion of the importance of market structure.

[5] Among the Fifth District states, only Maryland grants MSB charters. Federal charters are not available.

[6] The minimum statutory capital requirements, which have not changed for a number of years, are summarized in [3, pp. 8-9].

of organization is not available to S&L's that desire Federal charters. Minimum financial requirements governing market entry, expressed in terms of initial deposit subscriptions and general reserve and/or expense funds, are specified in the laws of Maryland and Virginia. North Carolina, South Carolina, and West Virginia requirements are determined as a matter of policy by the state regulatory authorities. For Federally chartered S&L's, minimum capital requirements are established by the Federal Home Loan Bank Board. Maryland law requires that newly formed MSB's have a minimum guaranty fund equal in amount to the minimum capital stock required of newly formed state banks.

Table I

MINIMUM CAPITAL REQUIREMENTS

Applicants for Federal Charter or Insurance

March 1976

Population of Area*	Total: Permanent Stock and Paid-In Surplus†	Withdrawable Capital: Stock Applicant	Withdrawable Capital: Mutual Applicant
Below 10,000	$ 150,000(30)	$225,000(225)	$ 300,000(250)
10,001-25,000	200,000(40)	300,000(250)	400,000(300)
25,001-50,000	300,000(60)	375,000(275)	500,000(350)
50,001-100,000			
Downtown	400,000(80)	400,000(300)	550,000(400)
Other Areas	300,000(60)	375,000(275)	500,000(350)
100,001-200,000			
Downtown	500,000(100)	450,000(325)	600,000(450)
Other Areas	400,000(80)	400,000(300)	550,000(400)
200,001-350,000			
Downtown	600,000(120)	525,000(375)	700,000(550)
Other Areas	500,000(100)	450,000(325)	600,000(450)
350,001-500,000			
Downtown	700,000(140)	600,000(450)	800,000(650)
Other Areas	600,000(120)	525,000(375)	700,000(550)
500,001-750,000			
Downtown	800,000(160)	675,000(525)	900,000(700)
Other Areas	700,000(140)	600,000(450)	800,000(650)
750,001-1,000,000			
Downtown	900,000(180)	750,000(600)	1,000,000(750)
Other Areas	800,000(160)	675,000(525)	900,000(700)
Over 1,000,000			
Downtown	1,000,000(200)	950,000(725)	1,250,000(850)
Other Areas	900,000(180)	750,000(600)	1,000,000(750)

*In determining population, the basic criterion of measurement is the aggregate metropolitan area. In applying the concept to specific cases, consideration is given to community characteristics, trade patterns, and the nature and degree of real estate development.

†Generally, the amount of paid-in surplus should approximate 20 percent of the amount of permanent stock.

( ) = Minimum number of subscribers. Minimum number of subscribers to withdrawable capital of stock applicant may be reduced by number of others subscribing to permanent stock.

Source: Federal Home Loan Bank of Atlanta.

Although state laws and policies are rather specific with regard to the minimum financial requirements that must be met by newly formed state chartered banks and S&L's, *in practice* they are of limited significance. This is so because of the widespread additional requirement that Federal deposit insurance be obtained before a state charter can be granted. Every District state, either as a matter of law or policy, requires that banks organizing under state charter obtain FDIC insurance. South Carolina and Virginia require FSLIC insurance as part of the chartering process for S&L's, and Maryland and North Carolina require either FSLIC insurance or deposit protection from a state chartered savings share association. Only West Virginia has no insurance requirement for state chartered S&L's.[7] Maryland requires that MSB's be insured by the FDIC.

Federal deposit insurance is required of all Federally chartered institutions. FDIC insurance qualification is an automatic part of the chartering process for national banks. The Federal Home Loan Bank Board administers the FSLIC program, and the financial requirements for S&L's organizing under a Federal charter are identical to those for associations organizing under state charter and seeking FSLIC insurance.

FDIC standards of capital adequacy for organizing banks, therefore, constitute the *effective* financial requirements governing market entry throughout the Fifth District. FDIC capital adequacy standards are arrived at on the following basis. An organizing bank's deposit growth is projected three years into the future, and initial capitalization, in the form of stock and surplus, must equal 10 percent of the projected deposit figure. In no event, however, can initial capitalization fall below $250,000. *Effective* financial requirements governing market entry by S&L's in South Carolina and Virginia are those established by the Federal Home Loan Bank Board and are listed in Table I. These requirements also apply to FSLIC insured S&L's in Maryland and North Carolina; associations in these states opting for savings share association insurance must meet financial requirements established by the states. Maryland law requires S&L's to have an initial deposit subscription of $100,000, a general reserve

[7] It should be noted, however, that there have been no S&L applications for state charters in West Virginia for a number of years. The reasons for this will become clear shortly. West Virginia industrial loan companies must qualify for FDIC insurance before a state charter is granted.

Table II

REGULATIONS GOVERNING BRANCHING

Fifth Federal Reserve District

March 1976

Institutional Type	Chartering Authority						
	Federal	State					
		Maryland	North Carolina	South Carolina	Virginia	West Virginia	District of Columbia
Commercial Banks	Subject to the branching laws of the state in which they operate. Prior approval by Comptroller of the Currency required.	Permitted statewide. Prior approval by Bank Commissioner required.	Permitted statewide. Prior approval by Commissioner of Banks required.	Permitted statewide. Prior approval by Board of Bank Control required.	Limited de novo branching permitted.[1] Branching by merger permitted statewide. Prior approval by State Corporation Commission required.	Prohibited.	Permitted throughout the District. Prior approval by Comptroller of the Currency required.
Savings and Loan (Building and Loan) Associations	Permitted within a 100 mile radius of home office, and under certain conditions further, but not across state lines; if state laws allow greater branching freedom, then Federally chartered institutions may follow state branching regulations.	Permitted statewide. Prior approval by Board of Building, Savings and Loan Association Commissioners.	Permitted statewide. Prior approval of Administrator of Savings and Loan Division required.	Permitted statewide. Prior approval by Board of Bank Control required.	Permitted statewide. Prior approval by State Corporation Commission required.	Prohibited.	Permitted throughout the District. Prior approval by Federal Home Loan Bank Board required.
Mutual Savings Banks	Not applicable.	Permitted statewide. Prior approval by Bank Commissioner required.	Not applicable.	Not applicable.	Not applicable.	Not applicable.	Not applicable.

[1] De novo branching permitted: a) within the city or county of parent bank; b) within cities contiguous to the county or city of parent bank; c) within counties contiguous to the city of parent bank, up to 5 miles from city limits; and d) at certain Federal and state installations.

Source: Federal and state statutes.

fund equal to 6 percent of the initial subscription, and an expense fund equal to 25 percent of the initial subscription. North Carolina requires an initial subscription of $750,000 and a reserve fund of $50,000. As already mentioned, MSB's chartered by the state of Maryland must conform to the FDIC standards specified above.

It would appear that in those states where not only banks but also S&L's must meet Federal deposit insurance financial standards, namely South Carolina and Virginia, the relative difficulty of market entry is about equal. The same is true for banks and Federally insured S&L's in North Carolina; and for banks, Federally insured S&L's, and MSB's in Maryland. In these two states market entry by state chartered S&L's that elect savings share association insurance, however, is considerably easier than for banks or Federally insured S&L's. Inasmuch as no statutory provision or policy governing Federal deposit insurance or minimum financial requirements exists in West Virginia, it is difficult to judge what standards would apply to S&L's seeking a state charter.

Branching State laws govern the branching activities of both Federally and state chartered commercial banks. This exception to the dual banking system has as its origin the McFadden Act of 1927, which gave national banks explicit sanction to establish full service branches in their home office cities but only in states where state chartered banks were permitted to branch. Subsequently, the Banking Act of 1933 allowed national banks to branch anywhere in their home office state subject to the restrictions imposed on state chartered banks by state law. Table II, a summary of state branching laws in the Fifth District, shows that statewide *de novo* bank branching is permitted in Maryland, North Carolina, and South Carolina. Virginia allows limited *de novo* bank branching and statewide branching by merger, while branching is prohibited in West Virginia. Federal law permits citywide bank branching in the District of Columbia.

The branching regulations that apply to Federally and state chartered S&L's, unlike commercial banks, are not uniform by state. This is because branching privileges specified for Federally chartered associations are not constrained by state laws. Federal chartering of mutual S&L's was established by the Home Owner's Loan Act of 1933, which gave the Federal Home Loan Bank Board general statutory authority for the incorporation, supervision, and regulation of these institutions.[8] From the outset, the Bank Board interpreted the Act as giving it discretionary authority to authorize branching by Feder-

[8] The Federal Home Loan Bank Board came into being, as part of the Federal Home Loan Bank System, with passage of the Federal Home Loan Bank Act in 1932. As initially established, the System's primary responsibilities were to provide added liquidity to member associations through direct advances and to meet recurring needs for more loanable funds than the immediate inflow of deposits might supply.

ally chartered S&L's. This interpretation has been challenged, but the Federal courts have ruled that the Bank Board does have such discretionary authority and, furthermore, that this authority is not limited by the extent to which state chartered associations are allowed to branch. Also, a number of unsuccessful attempts have been made to amend the Home Owner's Loan Act of 1933 by making state branching laws the ultimate constraint on branching by Federally chartered S&L's.

Current Federal Home Loan Bank Board regulations permit Federally chartered S&L's to operate branches, including mobile facilities, virtually statewide. General application can be made to establish branches within a 100 mile radius of the home office but not, in any event, across state lines. A recently adopted regulation, effective March 12, 1976, allows Federally chartered S&L's to establish branches or mobile facilities in rural areas without restriction on distance from home office. Federal associations may conform to state branching laws if these permit greater branching freedom than the Federal Home Loan Bank Board regulations.

The laws of four Fifth District states, Maryland, North Carolina, South Carolina, and Virginia, provide for statewide branching by S&L's. In these states Federally chartered associations also branch statewide. West Virginia law prohibits branching by S&L's, and Federally chartered associations operating in the state conform to the more liberal Federal Home Loan Bank Board regulations. All District of Columbia S&L's operate under Federal charters, and branching is permitted citywide. Maryland MSB's are allowed to branch statewide.

With regard to branching privileges, banks and nonbank thrift institutions are treated equally in three District states, Maryland, North Carolina, and South Carolina, and in the District of Columbia. In Virginia S&L's enjoy somewhat greater branching privileges in comparison to those under which banks operate. In West Virginia there exists a direct asymmetry between banks and state chartered S&L's on the one hand, which are prohibited from branching, and Federally chartered S&L's on the other, which enjoy what amounts to statewide branching.

Conclusion In reviewing the regulations governing market entry and branching by Fifth District financial intermediaries, this article has described one set of factors that influence market structure. It is clear that these regulations often differ among states and sometimes among institutional types within any given state. The regulatory setting, therefore, must be given explicit attention in market structure studies that consider competition between banks and thrift institutions.

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