BANKING UNDER CHANGING RULES: THE FIFTH DISTRICT SINCE 1970

David L. Mengle

Commercial banking has traditionally been one of the most tightly regulated industries in the United States. The controversies surrounding the First and Second Banks of the United States, the National Bank Act of 1864, the Federal Reserve System, and federal deposit insurance all attest to the concern shown with banking throughout our history. Further, desire to control concentration of economic power and to keep banking responsive to local interests led to restrictions on branching and interstate operations as well as, more recently, antitrust scrutiny of bank mergers.

Despite the tradition of regulation, the 1980s have seen a call for at least partial deregulation of banking. Deregulation is aimed neither at supervision of bank soundness nor at consumer protection measures, but rather at rules that constrain what banks may sell, where they may sell it, and the interest rates they pay on their deposits. So far, the largest number of successful deregulatory efforts have loosened constraints on where banks may do business.

But banking deregulation did not begin in the 1980s. In fact, the Fifth District provides a case study of how banking laws and regulations have evolved since 1970. For example, District commercial banks have seen changes in bank holding company laws, in branching restrictions, and now in barriers to banking across state lines. And as the law has evolved, so has the structure of banking in the District.

The Fifth District Regulatory Environment in 1970

Banking, like other industries, must be responsive to both state and federal law. But banking's competitive structure, unlike that of most other industries, has been shaped to a large degree by laws that vary among states. The most important state laws affecting banking structure in 1970 were branching restrictions. Among the most important federal laws were those governing bank holding companies.

Branching Laws In much of the Fifth District in 1970, banks could branch without restriction within their states subject only to approval by their regulators. Specifically, Maryland, North Carolina, South Carolina, and the District of Columbia allowed statewide branching. At the other end of the spectrum, West Virginia permitted neither branching nor multibank holding companies.

Between the statewide branching states and West Virginia stood Virginia, which allowed a bank to branch within its home city or county and within contiguous cities or counties. But the law was not quite so restrictive as it sounded because a 1962 amendment allowed a bank to expand in two other ways: First, it could merge with a bank anywhere in Virginia. Second, it could form a bank holding company which could in turn purchase banks anywhere in the state. The law actually favored the bank holding company route over the merger route because a bank acquired by merger would generally lose its branching privileges while a bank acquired by a bank holding company could still branch in its home area. In practice, then, all Fifth District jurisdictions except West Virginia had liberal laws regarding expansion of banks within their borders.

But full-service banking stopped at a state's boundaries. Whatever a state's laws regarding expansion within the state, two federal laws kept a bank from expanding into another state: First, the McFadden Act of 1927 (as amended in 1933) prohibited national banks from branching outside their home states. Second, the Douglas Amendment to the Bank Holding Company Act of 1956 forbade bank holding companies to acquire banks in other states unless the acquiree's state specifically permitted such acquisition. And in 1970, no Fifth District state extended the privilege to any other state's bank holding companies.

Bank Holding Company Laws and Regulations Another aspect of the 1970 legal environment was the impetus to growth of bank holding companies even in states permitting statewide branching. For example, a holding company could sell commercial paper and then pass the proceeds downstream to subsidiary banks. As interest rates rose in the late 1960s and banks began to face problems raising funds under

Regulation Q interest rate constraints, the holding company route presented an appealing alternative. Further, until September 1970 funds raised by a holding company and then passed downstream were not subject to reserve requirements.

There were also differences in how federal law treated different types of holding companies. Specifically, the Bank Holding Company Act subjected companies owning more than one bank to regulation by the Federal Reserve but made no provisions for companies owning only one bank. One-bank holding companies were consequently subject to fewer restrictions on activities and product offerings than were multibank holding companies. Thus there was incentive to attempt to initiate new financial services in a holding company subsidiary rather than apply for permission from regulators to conduct the activity within the bank and risk legal challenge from those threatened by the competition.

It became increasingly apparent in the late 1960s that Congress would bow to the Federal Reserve's urgings that the one-bank holding company loophole be closed. Still, the number of one-bank holding companies more than doubled between May 1968 and December 1970. Evidently, many banks felt compelled to switch to the holding company form in hopes they would be "grandfathered" under any new restrictions.

Thus the structure of Fifth District banking in 1970 reflected two main aspects of the laws in place at the time: First, multibank holding companies dominated in Virginia where they constituted a means of expanding throughout the state. But because they were regulated by the Federal Reserve, their ability to expand into new financial fields was limited. Second, one-bank holding companies were important in Maryland, the District of Columbia, and the Carolinas. Apparently, banks with statewide branching privileges were in a position to choose an organization form on the basis of product rather than geographical diversification.

Changes after 1970

The years following 1970 were a period of rapid growth for Fifth District banking. While the number of banks did not necessarily increase in all states, the number of branches did. Banking services therefore became more widely available. As one would expect, the growth occurred during a period of change in the regulatory environment.

Bank Holding Company Act Amendments The first significant change came in December 1970 when Congress amended the Bank Holding Company Act. The amendments essentially closed the one-bank holding company loophole by subjecting almost all bank holding companies to Federal Reserve regulation. In addition, Congress gave the Board of Governors authority to approve or deny nonbanking activities on a case-by-case basis subject to the requirement that activities be "so closely related to banking . . . as to be a proper incident thereto" and that the anticipated benefits, such as convenience, competition, and efficiency, outweigh anticipated costs such as conflicts of interest and increased concentration.

The initial effect of the new legislation was diversification of bank holding companies into new financial activities. During the early 1970s, for example, the Board approved such nonbanking activities as mortgage banking, factoring, leasing, financial data processing, and credit life insurance underwriting.

But in the mid-1970s, two sets of events may have helped slow the entry of bank holding companies into new activities: First, the failures of two New York banks, Franklin National and Security National, pointed to the problems faced by banks attempting to expand without sufficient regard for their capital base. Second, during the recession of the mid-1970s many banks experienced problems with their asset portfolios. In particular, some banks that advised real estate investment trusts (REITs) committed extensive resources to keeping certain REITs afloat. While bank holding companies were ostensibly under no obligation to support the REITs, the record does show that bank earnings suffered as a result of the support they did provide.

Consequently, the Board shifted to a "go slow" policy toward diversification into new activities. But despite the announced policy of slowing entry into nonbanking activities, there was no reversal of the movement toward the bank holding company organization form. Of the one hundred largest banking organizations in the United States, the number not affiliated with a bank holding company declined from twenty-eight in 1970 to three in 1975, two in 1980, and none by the end of 1981.

Statewide Branching The next significant changes affecting bank expansion in the Fifth District involved liberalization of branching laws in two states. The first occurred in Virginia in 1978 when the legislature extended branching privileges (still limited to contiguous jurisdictions) to acquired banks. Under the amended law, a bank could acquire another bank, turn it into a branch, and still establish branches in the area of the new branch. In practice, then, Virginia had adopted statewide branching even though (until 1986) the letter of the law limited branching to contiguous areas. By 1979, four of the five largest Virginia bank holding companies had consolidated their subsidiaries as branches under one bank. And by 1987 there were 112 fewer banks but 316 more branches operating in Virginia than there had been a decade earlier.

The other liberalization occurred in West Virginia. In 1982 the legislature voted to allow branching within a bank's home county starting in 1984 and also to permit banks to form multibank holding companies. The law was loosened again in 1984 to allow branching in contiguous counties beginning in 1987 and statewide branching in 1991. But two years later the legislature moved statewide branching up to 1987. The result is that all Fifth District states now allow statewide branching.

Interstate Banking The third event of significance to Fifth District banking structure was the passage by District state legislatures of laws permitting interstate banking. The first District state to enact such a law was South Carolina in 1984. The law provides for regional reciprocal entry, that is, it permits bank holding companies in the Southeast (defined as Maryland, West Virginia, Kentucky, Arkansas, and states to their south) to acquire South Carolina banks and bank holding companies provided their home states extend the same privileges to South Carolina banking companies. But the law effectively blocks de novo entry by prohibiting acquisitions of banks less than five years old.

Similar laws were passed in North Carolina in 1984 and Virginia in 1985. The Supreme Court gave regional interstate banking a further boost in June 1985. In *Northeast Bancorp v. Board of Governors* the Court upheld the constitutionality of state laws that limit entry to bank holding companies within a specified region. The principal losers from the decision were the money center banks, especially those in New York. The winners were regional banks hoping to build up size before any of their states got around to allowing money center banks to enter.

The approaches to interstate banking followed by Maryland, the District of Columbia, and West Virginia differ somewhat from those of Virginia and the Carolinas. Maryland's 1985 law now permits reciprocal interstate entry by banks in most of the Southeast plus Pennsylvania and Delaware. Other Maryland laws permit bank holding companies from other states to establish full-service de novo facilities provided they meet certain capital, investment, and employment requirements.

In the District of Columbia, a 1985 law permits entry by acquisition by bank holding companies from most of the Southeast. Another law, passed in 1986, allows entry of bank holding companies agreeing to provide loans and lines of credit, jobs, and branches for specified economic development projects and areas. Finally, a law passed by West Virginia in 1986 allows reciprocal entry by bank holding companies from anywhere in the nation subject to the restriction that no company can control more than 20 percent of deposits in the state.

Fifth District Banking Today

Interstate banking has sired a new breed of banking animal: the superregional bank holding company, defined as a bank headquartered outside the traditional money center cities of New York and Chicago and operating commercial banks in more than one state. The importance of the superregionals in the Fifth District is shown by two statistics: First, by the end of 1987 about 44 percent of deposits held by the six largest Fifth District bank holding companies were in banks outside their home states. Second, 30 percent of the deposits held by those six bank holding companies were in banks located in states outside the District.

The number and location of interstate acquisitions made by Fifth District bank holding companies appear in the accompanying table. North Carolina bank holding companies have looked mostly

FIFTH DISTRICT INTERSTATE ACQUISITIONS

(AS OF OCTOBER 1988)

ACQUIREE'S STATE

ACQUIRER'S STATE	DC	MD	VA	WV	NC	SC	FL	GA	TN
DC		2	3						
MD	2		1	1					
VA	4	6		2			1	1	16
WV									
NC		1	1			9	21	10	1
SC									
FL									
GA						3			
TN									

Number of acquisitions equals number of transactions and does not necessarily reflect number of banks acquired. A transaction is omitted if it does not involve a Fifth District organization.

southward to South Carolina, Georgia, and Florida. Companies in Virginia, Maryland, and the District of Columbia have concentrated on the so-called "Golden Crescent" region stretching from Baltimore south through Washington to Richmond and Norfolk. In addition, two Virginia banks have established a substantial presence in Tennessee.

Also reflected in the table is the paucity of entry by bank holding companies from outside the Fifth District. The only acquisition of a large Fifth District commercial bank so far has been by a Georgia bank headquartered in Atlanta.

Why have so few banks entered from outside the District? One explanation is that regional interstate banking has limited the pool of entrants. But this does not explain the lack of entry from other southeastern states. It is likely that banking laws of neighboring states have been in good measure responsible. Florida had unit banking until 1977 and limited branching until 1980, while Georgia and Tennessee were and still are limited branching states. In addition, Georgia restricted multibank holding companies until 1976. In contrast, District banks had few legal obstacles to expansion within their states and thus were in a position to take advantage of interstate banking when it became legal.

But the action in Fifth District banking has not been confined to the superregionals. In West Virginia, banks have established 168 branches and formed 52 bank holding companies since the legislature relaxed branching and holding company restrictions. Over the same period, the number of banks has declined by only 14. In addition, the ranks of small Fifth District banks (those with less than $100 million in assets) have been augmented by 18 new banks in 1985, 24 in 1986, and 21 in 1987. More important, small District banks' return on assets has averaged 1.03 percent since 1980 compared with 0.81 percent for banks with over $1 billion in assets.

What Next?

Now that the laws governing structure and expansion within a state have been liberalized in all Fifth District jurisdictions, what lies ahead for Fifth District banks and banking laws? Nationwide interstate banking is one possibility, more de novo entry is another, and interstate branching is yet one more.

Nationwide Interstate Banking As other states catch up with those in the Southeast in enacting interstate banking laws, it is reasonable to expect some banks outside the Southeast to show interest in entering the Fifth District. But what about expansion outside the Southeast by Fifth District banks? NCNB expanded into Texas in late 1988 by acquiring an interest in the failed FirstRepublic Corp of Dallas, but no other major expansion of a Fifth District bank outside the Southeast has yet occurred. Still, one might argue that it may soon be time to consider opening the region to entry from the rest of the nation, especially since the southeastern states are now lagging behind other states in providing for eventual nationwide entry. There are at least two groups of banks that could benefit from a liberalization of the interstate laws.

First, the superregionals in the Fifth District may start looking at likely markets outside the region once they have reached their desired levels of activity within the Southeast. But in many states they would be frustrated by interstate banking laws that allow entry only if banks in their own states can enter the acquirer's state. So potential acquirers may have incentives to work for abandonment of regional in favor of nationwide interstate banking.

A second group, potential acquirees, might also benefit from nationwide interstate banking. As most of the potential acquirers within the region find suitable partners, the remaining potential acquirees might wish to expand the pool of available suitors. Opening the Southeast could benefit small- and medium-sized banks in particular because some superregionals might prefer to enter on a modest scale rather than to swallow and digest another superregional.

De Novo Entry A further means of opening up interstate banking is by permitting more de novo entry. Most Fifth District interstate banking laws permit entry only through acquiring an existing bank. Indeed, blocking de novo entry probably made interstate banking laws more palatable to bankers by limiting the options of would-be acquirers and thereby raising acquisition values. But as merger premiums are bid up by entrants, the de novo option may become more attractive as an alternative to acquisition. Further, since restrictions on entry probably lead to less competition for loans and deposits, consumer advocates may push for liberalized de novo entry.

Despite advantages to consumers and to banks seeking to enter a state, it is unlikely that there will be much pressure at the state level to allow de novo entry. Acquirers come from outside a state and therefore may not have their interests represented in state legislatures other than their own. At the same time, banks that would lose from de novo entry are probably well represented at the state level. It is more likely that pressure would come at the federal level if and when Congress were to address interstate banking. In particular, both consumer advocates and superregionals might be better able to influence the course of legislation in Congress than in the many state legislatures.

Interstate Branching A final innovation that may someday come to interstate banking is interstate branching. At present, neither federal nor state (except Massachusetts) laws permit banks to branch across state lines. As a result, the superregionals must maintain separate subsidiary banks for each state. But if the experience in Virginia is any guide, branching may be a more efficient means of expansion for many banks. Most Virginia bank holding companies consolidated their subsidiaries into branches as soon as the law allowed it. The superregionals might have incentives to do the same thing if the law so allowed. Further, consumers might benefit from interstate branching. Not only would customers have ready access to their accounts when traveling, but checks could clear faster if superregionals were to use one set of books rather than the books of several subsidiaries.

But it is unlikely there will be much pressure for interstate branching in the immediate future. One obstacle is the question of jurisdiction over out-of-state branches. That is, if a bank establishes a branch outside its home state, who regulates the branch? Another obstacle is that it is simpler to expand by branching than by setting up subsidiaries. Potential competitors of a superregional might not be inclined to support any law that would make it easier to compete with them. As with de novo entry, the question of interstate branching might be more appropriately dealt with at the federal than at the state level.

Concluding Comment

The uncertainty of further liberalization should not cloud the central fact of the evolution of Fifth District banking: the substantial reduction in legal and regulatory obstacles to competition among banks. Future competition is likely to come from several sources: First, foreign banks may play an increasing role. Second, banks may face increased competition from the thrift industry once the current deposit insurance problems are resolved. Finally, commercial and nonbank financial corporations are attempting to encroach on commercial banks' traditional turf just as banks attempt to move beyond their own. Given such prospects, any attempts to regulate competition among banks seem beside the point. The current trend toward liberalizing restraints on interbank competition is likely to continue unabated.

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