United States General Accounting Office

GAO

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

December 1994

INTERSTATE BANKING

Experiences in Three Western States

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-258203

December 30, 1994

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

Dear Mr. Chairman:

This report responds to your request that we review the potential impact of lifting restrictions on interstate banking. Supporters of a nationwide interstate banking law have argued that geographic restrictions no longer make sense in today's integrated financial and credit markets and, further, undermine the ability of U.S. banks to compete domestically and internationally. Opponents, however, feared that relaxing geographic restrictions could result in a concentration of economic power among a relatively small number of banks. Given these conflicting views, you asked us to review the experiences of some states that have had interstate banking for some period of time. Congress recently passed legislation lifting some restrictions on interstate banking and branching. On September 29, 1994, the President signed into law the Interstate Banking and Branching Efficiency Act,[1] hereafter termed the Interstate Banking Efficiency Act.

In our November 1993 report,[2] we reported on interstate banking and its (1) potential effect on the banking industry's structure nationwide; (2) implications for the safety and soundness of the banking industry, the Bank Insurance Fund[3], and the economy; and (3) associated risks and ways to minimize them. In that report, we said that the best way to minimize the potential risks to the quality and availability of banking services arising from interstate banking is to ensure that markets remain competitive through vigilant antitrust enforcement and that laws and regulations governing credit availability are enforced.

This report discusses the experiences of three western states—California, Washington, and Arizona—which have operated in an environment permitting interstate banking and in-state branching. Specifically, we evaluated their experiences to determine whether these geographic laws

[1]P.L. 103-328.

[2]Interstate Banking: Benefits and Risks of Removing Regulatory Restrictions (GAO/GGD-94-26, Nov. 2, 1993).

[3]A deposit insurance fund operated by the Federal Deposit Insurance Corporation (FDIC). This fund generally insures deposits in banks up to $100,000 per account in interest and principal.

have had any effect on the (1) market share and number of large banks,[4] (2) viability of smaller banks,[5] and (3) availability of credit to small businesses.[6] This report provides useful information for Congress and regulators on the potential impact on states of lifting certain geographic restrictions.

Background

Prior to the passage of the Interstate Banking Efficiency Act, Congress largely had ceded to the states the power to determine how bank holding companies could branch within states or expand across state lines. Generally, states could permit a bank holding company to expand by (1) interstate banking—acquiring bank subsidiaries outside its home state; (2) interstate branching—establishing branches outside its home state; and (3) in-state branching—acquiring branches throughout all or part of its home state.[7]

Section 3(d) of the Bank Holding Company Act of 1956, commonly known as the Douglas Amendment, prohibited bank holding companies from acquiring a bank subsidiary in another state unless the state where the acquired bank was located specifically permitted such acquisitions. The Douglas Amendment had two central purposes: (1) to help alleviate concerns that economic power could be concentrated among a relatively small number of nationwide banking institutions and (2) to keep national and state-chartered banks on an even footing by giving states, not the federal government, authority over interstate banking. The McFadden Act of 1927 generally barred interstate branching for all national banks and all state-chartered banks that were members of the Federal Reserve System.[8] A national bank was allowed to branch within its headquarters state to the extent that state law authorized branching by state banks.

[4]In California, we considered large banks to be those with more than $10 billion in assets, from December 1984 to June 1993. In Washington and Arizona, however, we were not able to use this categorization because only one bank of this size existed in each state in most of those years. Nonetheless, banks with more than $1 billion in assets in these states had a statewide presence similar to those with more than $10 billion in assets in California. We therefore considered large banks in Washington and Arizona to be those with more than $1 billion in assets.

[5]Smaller banks refer to those with $1 billion or less in assets in all three states.

[6]The Small Business Administration (SBA) defines small businesses as independent firms employing fewer than 500 workers.

[7]Bank subsidiaries are separately chartered and regulated institutions that are part of bank holding companies. Bank branches are offices of the bank and, as such, do not have separate capital requirements.

[8]The Federal Reserve System is the central banking system in the United States, consisting of 12 district banks and the Board of Governors. National banks are required by law to own stock in the Federal Reserve bank in their district. State-chartered banks have the option of becoming members or remaining nonmembers.

Over time, most states relaxed their interstate banking laws by enacting laws authorizing out-of-state bank holding companies to acquire in-state banks and bank holding companies. Many of these state laws had nationwide triggers, which allowed holding companies from anywhere in the country to acquire banks in those states. By year-end 1993, all but one state—Hawaii—permitted some form of interstate banking. Most states had laws permitting in-state branching. However, only eight states permitted interstate branching, and only for state-chartered Federal Reserve nonmember banks.

Although most states had relaxed their interstate banking laws, some bankers urged Congress to enact a nationwide banking and branching law to facilitate the banking industry's ability to compete. They argued that without a nationwide law, banking companies must deal with each state separately, and that this was an expensive and inefficient process. Proponents of a nationwide interstate banking and branching law believed that removing restrictions would strengthen the banking industry and benefit customers by (1) increasing competition and geographic diversification, (2) reducing the need for customers to maintain separate accounts in different states, and (3) offering a wider range of products and services that are generally associated with larger banking companies.[9] Opponents feared such actions would lead to adverse effects such as excessively concentrating assets and deposits under large banks' control, impairing smaller banks' survival, and reducing small businesses' access to credit.[10]

Congress passed a nationwide interstate banking and branching law, the Interstate Banking Efficiency Act, during the second session of the 103rd Congress. This act authorizes the Federal Reserve Board, effective 1 year from the date of enactment, to permit adequately capitalized and adequately managed bank holding companies to acquire banks located anywhere in the United States outside of the acquirer's home state without regard to state laws. In addition, the act provides for interstate mergers and branching by FDIC insured banks in states where such activity is permitted. First, beginning June 1, 1997, banks may merge across state lines so long as the states involved have not enacted laws which expressly prohibit interstate mergers before that date. Interstate mergers earlier than

[9]For a further discussion of the benefits of interstate banking and branching, see GAO/GGD-94-26.

[10]Opponents of lifting geographic restrictions have other concerns such as increased fees and deteriorating customer service that may result from reduced competition. However, we have addressed some of these concerns in our report GAO/GGD-94-26. For a discussion of how geographic deregulation affected the three states we reviewed in this report, see appendix II through appendix IV.

June 1, 1997, are allowed in states having laws that expressly allow them. Second, out-of-state banks may acquire branches, without acquiring the bank itself, but only if the state where the branch is located permits such transactions. Finally, the act permits national and state nonmember banks to enter states for the first time through the establishment of a new branch, if the state has a law expressly permitting such branching.

Results in Brief

Although states' interstate banking and in-state branching laws provided large banks with the opportunity to expand, the experiences of California, Washington, and Arizona indicated that such geographic deregulation[11] did not necessarily result in a more concentrated industry.[12] One reason for the lack of significant additional consolidation[13] may have been that the banking industry in these states was already highly concentrated, reflecting previous consolidation.

In all three states, the experience of large banks was mixed; some grew, some declined, and others were acquired. On balance, large banks held no greater share of the three states' markets in June 1993 than they did at the end of 1984. However, both federal and state regulators became concerned about undue concentration when the two largest bank holding companies in the western states—BankAmerica and Security Pacific—requested approval for a merger. Before approving the merger, regulators proposed the divestiture of a number of branches.[14]

During the period December 1984 through June 1993, smaller banks, whether owned in-state or by out-of-state bank holding companies, continued to play an important role. They frequently were among the most

[11]Geographic deregulation is a general term that refers to interstate banking, interstate branching, and/or in-state branching.

[12]Concentration is measured by the amount of business handled by the largest banking companies within a market.

[13]Industry consolidation is characterized by a greater concentration of assets among the largest banking companies in the country. For more information on the concentration of the banking industry nationwide, see GAO/GGD-94-26; "Concentration in Local Markets," Stephen A. Rhoades, Economic Review, (Mar. 1985); "Trends in Banking Structure Since the Mid-1970s," Dean F. Amel and Michael J. Jacowski, Federal Reserve Bulletin, (Mar. 1989); and "Interstate Banking: A Status Report," Donald T. Savage, Federal Reserve Bulletin, (Dec. 1993).

[14]A divestiture refers to the sale of an asset to achieve a desired objective. A bank may sell branch offices or an entire operating division, for example, to cut expenses or carry out its business plan for long-term growth.

profitable banks as measured by return on assets[15] and, despite geographic deregulation, either gained additional market share or regained previously lost market share. In Washington and Arizona, this was caused in part because some smaller banks—especially in Arizona—were acquired by out-of-state bank holding companies.[16] By mid-1993, Washington's in-state smaller banks had regained most of the market share previously lost to out-of-state banks. Their market share rose to 17.6 percent from a low of 13.8 percent in 1989. However, in Arizona, smaller banks that were owned out-of-state gained market share at the expense of in-state smaller banks, with the latter's share falling from 11.2 percent in 1985 to 6.8 percent in June 1993.

Although over the period of our review, the market share of all smaller banks as a group did not generally decline, the market share of the smallest banks—those with less than $100 million in assets—did decline. In Arizona and Washington, most of this market share was lost to other small banks (those with assets from $100 million to $1 billion). In California, the smallest banks' lost market share was generally gained by small or midsized banks (those with assets between $100 million and $10 billion).

According to some bankers and focus group participants[17] we interviewed, large banks were credited with increasing credit availability to those small businesses in the three states that met the large banks' lending criteria. Other bankers and participants mentioned, however, that the practices of centralizing and standardizing loan decisions, common to large banks, could result in some small businesses having difficulty obtaining credit in markets where there are few alternatives to large banks.[18] They told us that the standardization of loan criteria, coupled with the removal of authorization for loan decisions by local bank officers knowledgeable about the community, impaired small businesses' access to credit. However, bankers from large banks told us that centralizing and

[15]Return on assets is calculated by dividing net income by total assets. This indicates how profitably a financial institution's assets are employed.

[16]A corporation that controls at least one bank.

[17]In each state, we met with three or four focus groups made up of administrators of nonprofit loan funds, individuals who helped businesses obtain bank financing by assisting them with loan applications for loans guaranteed by the states or the SBA, SBA officials, directors of city and county economic development departments, and former bankers. For a discussion of the benefits and limitations of these group discussions, see appendix I.

[18]Under a centralized and standardized system, loan officers working in a central location make loans according to standardized financial criteria. This system may depersonalize the relationship between the loan officer and borrower, making it difficult for the loan officer to take into account relevant credit information that is not captured using standardized criteria.

standardizing their bank operations had allowed them to become more efficient and in turn serve many more small businesses.

Some bankers and focus group participants attributed credit difficulties to a decline in the number of small banks or a change in lending emphasis from commercial lending to consumer lending by some banks that were acquired. They viewed smaller banks as strong providers of credit in the three states we visited even though they said these banks did not have a large presence in some inner cities and rural markets.

As we said in our November 1993 report, vigilant antitrust enforcement of the banking industry is necessary to ensure that any adverse impact of consolidation on certain segments of the small business sector is minimized. Such actions should increase the likelihood that small business loan needs are met.

The Three States Offer a Contrast

The three states we focused on—California, Washington, and Arizona—allowed us to examine interstate banking and in-state branching provisions in a variety of banking and economic environments. According to many observers, California's large size, diversified economy, and relatively consolidated banking industry provides one example of how the nation might fare under nationwide banking and branching. California law has permitted in-state branching since the early 1900s and interstate banking since 1987. Several large California banks have branched throughout the state, but out-of-state banks have no significant presence.

In contrast, once Washington and Arizona introduced interstate banking, out-of-state bank holding companies acquired the majority of the banking assets in each state. Washington had some restrictions on in-state branching until 1985 and passed interstate banking in two phases. First, in 1983, out-of-state banks were allowed to purchase failing in-state banks in Washington. Second, in 1987, out-of-state bank holding companies were permitted to purchase healthy Washington banks as long as the state where the acquirer was headquartered permitted reciprocal arrangements for bank holding companies headquartered in Washington. Arizona has had in-state branching since the 1870s and interstate banking since 1986.

California, the most populous state in the nation, was considered economically sound until the early 1990s. Washington is a middle-sized state that since the mid-1980s has, for the most part, exhibited steady but more moderate economic growth than California. Arizona, also a middle-sized state, has in recent years experienced rapid economic growth followed by an abrupt downturn. All three states had relatively high rates of economic growth from 1984 through 1990. California's and Washington's gross state products grew 60 percent and 58 percent, respectively, while the national gross domestic product grew 46 percent during this 6-year period.[19] Despite its economic problems, Arizona—whose gross state product grew by 52 percent—also grew at a faster rate than the nation as a whole. Although its real estate market suffered greatly, the remainder of Arizona's economy continued to grow.

The three states fared differently in the national recession that began in 1990. California began to suffer from the effects of the recession in 1990; as of year-end 1993, economists saw its recovery lagging behind the nation's. Washington, in contrast, did not begin to suffer the effects of the recession until mid-1991, and economists did not expect the recession to be as prolonged or as deep as it was in California. Finally, Arizona had experienced economic problems well before the national recession began in 1990. In the late 1980s, Arizona's economy was severely hit by a variety of factors, the most frequently cited being the collapse of the real estate market. However, according to economists in the state, Arizona, like the nation, has started its economic recovery.

Objectives, Scope, and Methodology

In examining the experiences of the three states, we focused on a broader period—December 1984 through June 1993—than the period when interstate banking laws became effective in those states. We did this because the three states phased in the relaxation of interstate banking laws over time. For example, California began lifting interstate banking restrictions in 1987; Washington in 1983; and Arizona in 1986. Further, two of the states—California and Arizona—have permitted in-state branching for many decades. In addition, many geographic restrictions on banking were removed by states permitting out-of-state banks to expand into the states we examined; many mergers among financial institutions occurred (some involving the largest banks in the western states); and a nationwide recession took place.

In each of the three states, to evaluate the degree of market share among large and smaller banks, we (1) analyzed call report data maintained by FDIC on banks' profitability and market share, along with data on mergers, failures, and new charters maintained by both federal and state

[19]The gross domestic product—the total national output of goods and services, valued at market prices—is a standard measure used to gauge economic growth. The gross state product is the state counterpart. The latest year for which state data are available is 1990.

regulators;[20] (2) reviewed economic research; and (3) met with regulators, bankers, and other interested parties. To assess the availability of credit for small businesses, we examined banks' asset portfolio data, interviewed bankers, and met with focus groups in 11 markets.[21] Our focus groups were composed of individuals who helped businesses apply for bank financing, SBA officials, officials of city and county departments of economic development, and former bankers.

Although the focus group results could not be statistically generalized as representative of small businesses, they offered us a practical means of obtaining a small business perspective on credit availability. Further, since the scope of our work was limited to California, Arizona, and Washington, we could not extrapolate our observations to other states.

FDIC provided written comments on a draft of this report. These comments are presented and evaluated on page 17 and 18 and are reprinted in appendix V. We also requested comments from the Office of the Comptroller of the Currency (OCC) and the Federal Reserve. OCC said it had no substantive comments and the Federal Reserve did not provide comments, which is its policy when we do not make recommendations.

We conducted our work from June 1992 through June 1994 in accordance with generally accepted government auditing standards. We present a more detailed discussion of our scope and methodology in appendix I.

Large Banks' Market Share in the Three States Changed Little

Studies have shown a link between the removal of branching restrictions and banking industry consolidation within a state. On the basis of such studies, many observers predicted that nationwide interstate banking and branching would also lead to consolidation. Such consolidation had not occurred in the three states covered by this report, in part perhaps, because the bank concentration levels for these three states were already high. For example, of the states with a large banking presence,[22] California had the second highest concentration level—with the three largest banks accounting for 62.3 percent of banks' assets. Of the states with a medium

[20]Call reports are quarterly reports of income and condition required by a financial institution's primary supervisory agency.

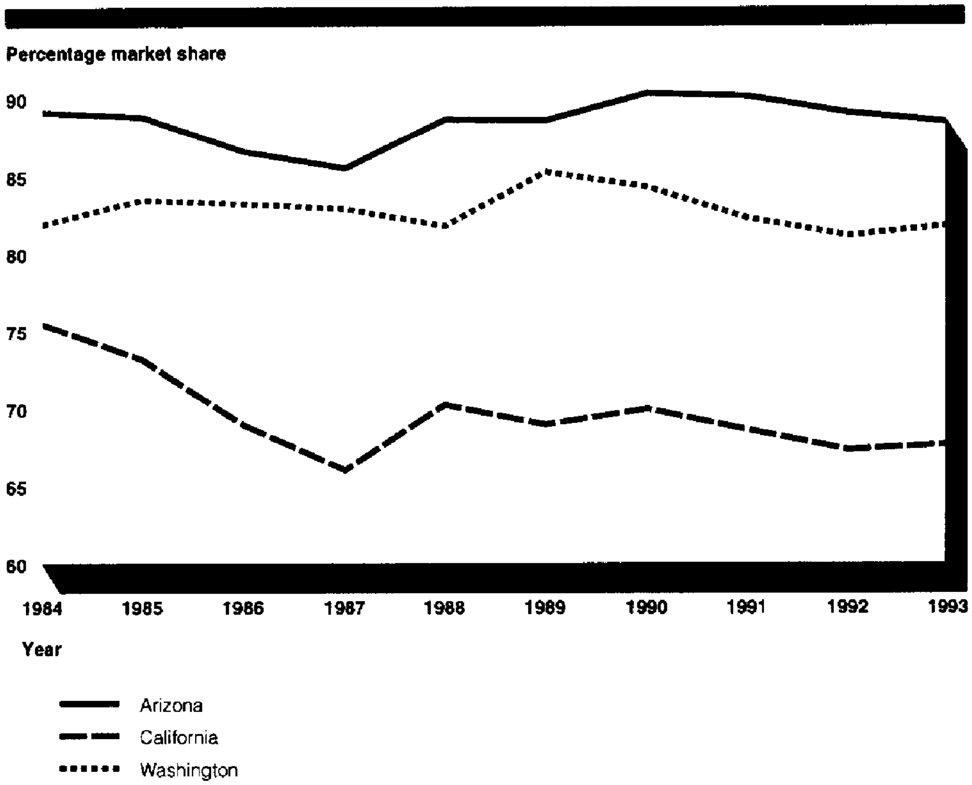
[21]These markets consisted of both urban and rural areas. Urban markets were defined using metropolitan statistical areas (MSA) and rural markets, which were not part of an MSA, were defined using counties. For a description of these markets see appendix I.

[22]We defined these as the 14 states with the largest amount of banking assets of all of the states. California ranked second.

banking presence,[23] Arizona and Washington had the highest and second highest concentration levels, with the three largest banks accounting for 82.6 percent and 62.4 percent of total bank assets, respectively.

Figure 1 shows that the market share the largest banks controlled within each of these states fluctuated over the period we reviewed. However, by mid-1993, these market shares either approximated 1984 levels or fell below those levels.

Figure 1: Market Share of Large Banks for 1984-1993



Note 1: Large banks in California are those with more than $10 billion in assets. Large banks in Washington and Arizona are those with more than $1 billion.

Note 2: 1993 data are as of June 30. All data for the other years are as of December 31.

Source: FDIC call report data.

[23]We defined these as the 12 states with the second largest amount of banking assets of all of the states. Of this grouping, Washington ranked ninth and Arizona, twelfth.

In all three states, some large banks increased their market share, while others saw their share decline or were acquired. Perhaps the most significant event was the 1992 merger of two large bank holding companies, BankAmerica Corporation and Security Pacific Corporation. The merger left BankAmerica with the largest or second largest bank in each of the three states. Table 1 shows the change in the market share of BankAmerica's subsidiaries[24] and their position in each state from 1984 to 1993. The subsidiaries' market share in each state would have been greater, if federal and state regulators had not encouraged BankAmerica to divest some of the branches of its subsidiaries in markets where they felt competition might adversely be affected because of its large presence. For example, without the 1992 divestiture in Washington state, BankAmerica's subsidiary—Seattle-First National Bank—would have had $1.5 billion more in assets than it did as of mid-1993.

Table 1: BankAmerica's Market Share and Ranking for 1984-1993

	1984		1993	
State	Market share	Ranking	Market share	Ranking
California	37.3%	1	41.3%	1
Washington	30.2	1	37.4	1
Arizona	[a]	[a]	28.3	2

Note: 1993 data are as of June 30. All other data are as of December 31.

[a]BankAmerica did not enter Arizona until 1990.

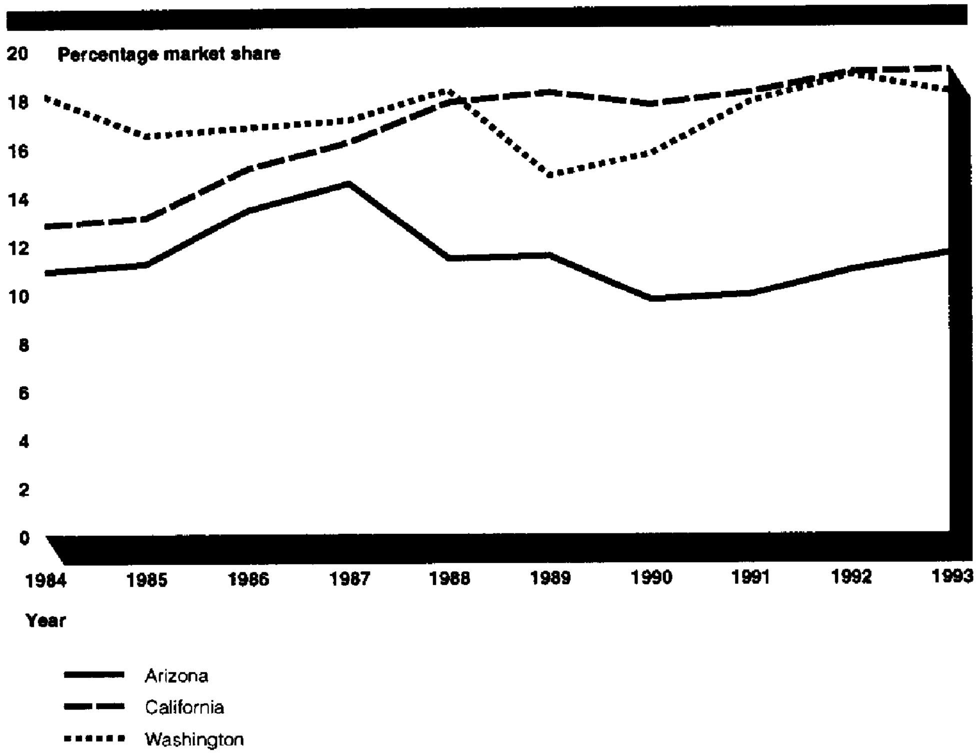
Source: FDIC call report data.

Smaller Banks Remained Viable

Throughout the period we focused on, smaller banks as a group remained viable in the three states. In fact, smaller banks were often among the most profitable banks in California and Washington when measured by return on assets. In Arizona, purchases by out-of-state bank holding companies helped maintain the viability of smaller banks through the infusion of capital. Although smaller banks' share of the market declined temporarily in Washington and Arizona, by June 1993 it had regained or even slightly exceeded its 1984 market share levels. (See fig. 2.)

[24]A subsidiary is a separately chartered and regulated bank that is part of the bank holding company. The California subsidiary is called Bank of America, the Washington subsidiary is called Seattle-First National Bank, and the Arizona subsidiary is called Bank of America Arizona.

Figure 2: Market Share of Smaller Banks for 1984-1993



Note: 1993 data are as of June 30. All other data are as of December 31.

Source: FDIC call report data.

Smaller banks as a group were recapturing market share. However, the smallest banks were losing market share to other small banks with assets from $100 million to $1 billion. Table 2 shows that banks with assets of less than $100 million declined in number and market share in the three states, while those with assets from $100 million to $1 billion increased in number and market share.

Table 2: Changes in Market Share Among Smaller Banks

	Banks with assets less than $100 million				Banks with assets from $100 million to $1 billion			
	1984		1993		1984		1993	
State	Number	Market share	Number	Market share	Number	Market share	Number	Market share
Arizona	37	3.8%	22	2.7%	5	7.1%	10	8.8%
California	346	4.7	250	3.9	89	8.3	176	13.3
Washington	87	9.8	65	6.4	9	8.3	20	11.8

Note: 1993 data are as of June 30; 1984 data are as of December 31.

Source: FDIC call report data.

Regulators, bankers, and many industry experts we spoke with believed that California's long history of in-state branching showed that smaller banks could successfully exist alongside large banks with statewide networks. Smaller banks would always survive, they contended, because such banks carved out special niches that large banks were unable or unwilling to fill.

The number of smaller banks first rose and then fell in California between 1984 and mid-1993, but the market share of smaller banks generally increased throughout this period. Regulators and bankers we spoke with attributed the reduced number more to an economic downturn than to competition from large banks with extensive branch networks. They attributed this decline to economic cycles because smaller banks tend to be more dependent on local economic fluctuations than larger, more diversified banks.

In Washington and Arizona, smaller banks had both out-of-state and in-state ownership. We therefore analyzed trends for these banks both as a single group within each state and by ownership in- or out-of-state.[25] In both states, the market share of smaller banks as a group increased during the first year that these states permitted interstate acquisitions of healthy banks (i.e., 1986 in Arizona and 1987 in Washington). These gains,

Table 2: Changes in Market Share Among Smaller Banks

	Banks with assets less than $100 million				Banks with assets from $100 million to $1 billion			
	1984		1993		1984		1993	
State	Number	Market share	Number	Market share	Number	Market share	Number	Market share
Arizona	37	3.8%	22	2.7%	5	7.1%	10	8.8%
California	346	4.7	250	3.9	89	8.3	176	13.3
Washington	87	9.8	65	6.4	9	8.3	20	11.8

Note: 1993 data are as of June 30; 1984 data are as of December 31.

Source: FDIC call report data.

Regulators, bankers, and many industry experts we spoke with believed that California's long history of in-state branching showed that smaller banks could successfully exist alongside large banks with statewide networks. Smaller banks would always survive, they contended, because such banks carved out special niches that large banks were unable or unwilling to fill.

The number of smaller banks first rose and then fell in California between 1984 and mid-1993, but the market share of smaller banks generally increased throughout this period. Regulators and bankers we spoke with attributed the reduced number more to an economic downturn than to competition from large banks with extensive branch networks. They attributed this decline to economic cycles because smaller banks tend to be more dependent on local economic fluctuations than larger, more diversified banks.

In Washington and Arizona, smaller banks had both out-of-state and in-state ownership. We therefore analyzed trends for these banks both as a single group within each state and by ownership in- or out-of-state.[25] In both states, the market share of smaller banks as a group increased during the first year that these states permitted interstate acquisitions of healthy banks (i.e., 1986 in Arizona and 1987 in Washington). These gains,