STATEMENT OF KEITH H. ELLIS

ON

THE ECONOMIC IMPACT OF FULL INTERSTATE BRANCHING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

MAY 15, 1991
Mr. Chairman, Members of the Subcommittee, I am Keith Ellis, the Delaware State Bank Commissioner. Although I am not before you today on behalf of the Conference of State Bank Supervisors, "CSBS," I chair that Association's Federal Legislation Committee and serve on its Board of Directors, and will attempt to reflect its positions as well as my own. I appreciate this opportunity to share my views on the issue of geographic deregulation of our banking system which, as you well know, Mr. Chairman, is very important to Delaware.

The outcome of the deliberations of this body are particularly important to Delaware because of the importance of the banking industry to our state. This fiscal year banks, through franchise taxes, contributed over one hundred dollars per Delaware resident to the state tax base. Recent analyses have pointed to the vitality of our banking industry as the primary factor in our recent economic resurgence and our relative strength within the region during these economic hard times.

I begin with the premise that no one really knows what will happen if and when we move to a system of full nationwide bank ownership and bank branching. Our banking system, like our political system, has historically been very decentralized. We can extrapolate from what we do know and think we understand. But this is bounded by the limits of our logic, our ability to identify and account for a myriad of variables, our ability to screen for bias and our ability to account for the aberations and inconsistencies of human behavior.
While I really can't tell you what the economic impact of interstate branching will be, I will raise four areas of concern: regulatory implications, tax impact, credit availability and the potential for increased concentration of economic resources.

At the outset, it should be noted that some cost-savings would accrue to interstate banking operations, largely through operational efficiencies and through capital consolidation. That these savings would approach the $15 billion projected by McKinsey and Company and relied upon by the Treasury Department is doubtful. I understand that two of the larger interstate banking operations, Bank of America and NCNB, have projected savings of $50 million and $20 million a year, respectively. This would suggest an aggregated industry figure of far less that $15 billion. In addition, it is unclear how much, if any, of these cost savings could be affected without full interstate branching, which, if any, of these cost savings are achieved at the expense of regulatory oversight and how much of an offset must be taken for increased tax burden.

Regulatory Impact

Through cooperative efforts, state and federal bank regulatory agencies have already begun coordinated interstate examination of multi-state banking operations. But "begun" is the key word, and time is necessary to assure that orderly accommodation of an evolving system may be accomplished. While a majority of state and federal agencies have entered information sharing agreements, information available to regulators will be reduced in an interstate branching environment as the conversion of affiliates to branches reduces the number of audits and examinations. This
is one of the cost savings which proponents of interstate branching hope to
effect, although reduced oversight in the name of "efficiency" may not be a
desirable public policy goal. The cost-effectiveness of redundant safety
systems is a subject for debate in any heavily regulated industry.

Beyond the mechanics of information gathering and sharing is the need
to preserve sufficient authority for public office-holders to meet their
responsibilities. All bank failures are local and public expectation, even
today, often exceeds retained local authority. Local depositors and
businesses whose lines of credit are interrupted really don't care if a
bank is regulated out of Washington, D.C., or has failed only because its
parent bank or lead bank affiliate has failed in another state.

While current proposals will make it increasingly easier to point the
finger at Washington, placing blame does not solve problems. If feasible,
some entity which is more than a mere branch should be retained in each
state. A level of management which is capable of being responsive to local
concerns and has knowledge of the local market should be retained. When a
loan application is turned down at a parent bank in another state, it is
your caseworkers and my complaint technicians who will get the call.

It is rightly pointed out that state regulators now have little to say
with respect to the operation of a national bank. Unfortunately, there is
near consensus among state regulators that the Office of the Comptroller of
the Currency is less diligent in ensuring compliance with applicable state
law requirements than state officials. While this may surprise no one, it
underscores a current problem which will likely worsen with the advent of
interstate branching. In addition, it is evidence of the political fact of
life that mere laws on the books are sometimes insufficient to effect
public policy. Those national banks with whom I do not visit may well be
acquainted with my Governor or Secretary of State. Our ability to effect a
working relationship with a branch manager or an officer at the
out-of-state parent is less sure.

State law is applicable to national banks where it is not in direct
conflict with federal law and does not frustrate the purposes of the
National Bank Act. Thus state laws relating from contracts to consumer
protection may be given effect. In addition, the Congressional grant of
authority under the Douglas Amendment has been interpreted as allowing
states to impose conditions on interstate entry to moderate perceived
dangers or to serve public policy objectives. Some states, like Delaware
distinguish between de novo entry and entry by acquisition. Some states
focus on economic development objectives, including local credit
availability, while others may impose specific minimum capital levels or
consumer protections. Preemption of statutes which reflect public policy
objectives of state legislatures should not be lightly undertaken. Repeal
of the McFadden Act and the Douglas Amendment to effect operational
cost-savings would do so.

Advocates for full nationwide branching have advanced the argument that
increased diversification can help avoid regional downturns. Yet, banks
can presently diversify their loan portfolios through loan production
offices or loan participations, just as Continental Illinois and Seafirst
participated in the economic downturn in Texas and Oklahoma. Moreover,
concentrations of loans in high growth areas appear unrelated to
geography. Money tends to flow where demand and return are high. This
concentration may actually increase as the need to reinvest in a
geographically defined deposit base is removed. One can send good money after bad through overcommitment in either too hot or too cold an economy. Management skill has a lot more to do with risk aversion than geography.

The need for orderly, measured change cannot be overemphasized. Rapid growth leading to reduced loan quality and management control breakdown may occur if a land rush mentality is allowed to develop. Also, mere size alone may make banks more difficult to monitor and more costly to underwrite through either bank-funded deposit insurance or public funds. Increased "hands on" regulation will demand renewed Congressional commitment to improving the quality of bank supervision and ensuring adequate funding for agencies.

I noted with interest that Section 246 of the Treasury proposal fails to tie interstate branching to the maintenance of Tier I capital, as is done for new activities and for regulatory sanctions. While I am not generally an advocate for elevating capital above all other measures of bank safety and soundness, interstate branching would appear to be the most logical place to do so. The combination of local deposit-taking with little or no local control over other regulatory factors and the general expansion of the deposit base, if anything, suggest the need for a sufficient capital buffer. I, for one, would prefer not to have branches of undercapitalized banks gathering deposits in Delaware. This apparent oversight can, I am certain, be easily remedied by amendment.
Tax Impact

I administer Delaware's bank franchise tax. I claim no expertise on tax law, but have reviewed materials prepared by Sandra McCray and others, including a perusal of the referenced case law. My review leads me to two concerns: that interstate branching may undercut the legal nexus for imposition of a franchise tax such as ours and that it may lead to double taxation of banks.

It is my understanding that approximately 27 states use a nondiscriminatory franchise tax imposed on the entire income of the domiciliary bank. Absent status as the state of domicile or the granting of a special privilege to a nondomiciliary bank, a state may not impose such a tax. In contrast, a number of states have embraced a system of minimal contact taxation which taxes that portion of income attributable to financial service users within that state.

The bases for imposition of a franchise tax appear threatened by repeal of the McFadden Act, since no special privilege is granted a branch and a branch has no domicile apart from that of its parent. The Conference of State Bank Supervisors has expressed serious concerns that the ability to tax income derived from federal obligations held by branches of national banks, as well as more general concerns that state taxing authority may be undercut by full interstate branching. Because full interstate branching does not exist, debate on future treatment of state taxing authority has been inconclusive.
The Treasury Proposal contains no resolution of competing systems of state taxation. If both are left to apply, the state tax burden of banks will increase significantly. Delaware has one of the lowest effective bank franchise tax rates in the country. We can assume that a minimum contact state taxes the same transaction at a higher rate. Delaware, as the state of domicile must then decide how to treat the tax paid to the other state. Dollar for dollar credit on tax paid could not be given because of the tax rate differential. Dollar for dollar credit on the underlying transaction leaves the institution paying a higher rate on the transaction and Delaware with no benefit, despite having superior contacts as the state of domicile, as well as the state whose law applies and the state from which credit is extended. Presumably, Delaware will assert its right to tax the income derived from the transaction, in whole or in part, resulting in multiple taxation. Things get even more complex when a consumer from State A buys something in State B with a credit card issued in State C.

The simplest solution, as suggested by the American Bankers Association is to affirm state taxing authority to impose a franchise tax where a bank or bank branch is physically located in a state. This would apply to the financial service industry the same rationale employed for taxation of retailers and manufacturers. It would allow for business planning to anticipate and account for the tax consequences of physically locating in a state. In addition, it would resolve the issue at the outset and forestall costly litigation for states and the banking industry alike.
Credit Availability

Presumably, a system of financial intermediation seeks to have all sectors of the economy and all geographic sectors adequately served. Historically, the well-being of a financial institution was directly tied to the economic well-being of the community in which it was located. The resultant local investment emphasis of banks had the positive effect of fueling local development but the down-side risks of non-diversification and monopolization.

Studies of the impact of branching and bank consolidation suggest reduced credit availability for small businesses and rural borrowers. However, these appear inconclusive. Logic tells us that it is easier and cheaper to make fewer large loans than many small loans. Yet, the need to diversify risk tends to limit loan concentrations. Community loyalty, both personal and economic, can be a positive factor, but may carry with it substantial risk to a poorly managed institution. In addition, the credit allocation effect of risk based capital, premiums and supervision may lead to reduced lending in certain sectors and a consolidation of resources at the parent bank or corporation.

The industry consolidation which accompanied the move to interstate bank ownership was followed by a period of adjustment in which real or perceived service gaps were filled. The greatest concern today is that barriers to entry and reduced profit margins will allay market forces. High entry fees, capital standards, premium levels and regulatory costs may deter new competition, leaving some sectors inadequately served.
The interstate banking experience suggests that interstate branching will accelerate the flow of credit in the economy. Nationwide networks of branches will funnel credit into growth economies and away from regions that are stagnant or experiencing a recession. This activity will tend to increase the boom-bust cycle experience in most regions.

Looking at the economic cycles in any of the regions that are currently experiencing severe stress, the dominating common factor is a period of robust growth prior to the decline. This growth resulted in overbuilding of commercial, industrial, and residential real estate. This overbuilding was fueled by credit policy decisions based on optimistic assumptions about maintaining the current growth rates. When the market begins to sour, lenders feel overexposed and tend to shut off new loans, even to good borrowers. This forces the downward stroke of the cycle deeper. By accelerating the flow of funds into an area during good times and out of it during bad, interstate banking and branching, along with advancing technology may add to the pocket recession phenomenon.
Concentration of Economic Resources

Deeprooted concerns over the concentration of economic resources are reflected in the legislative history of the McFadden Act and the Douglas Amendment. Senator Douglas emphasized that a primary purpose of his amendment was "to prevent an undue concentration of banking and financial power, and instead to keep the private control of credit diffused as much as possible." Now, however, the size achieved by foreign competitors, operating in systems without a bias against economic concentration has become a motivating factor for change.

In the near term, interstate branching will lead to a reduction in the number of banks. The total consolidation of the 160 multi-state bank holding companies would reduce the number of banks operating in the United States by around 300. This is not a significant reduction from the approximately 12,500 currently operating. This reduction will also be less because many holding companies would not fully consolidate. In the longer term, top end concentration will probably continue through mergers and acquisitions. Whether new local competition is spawned will depend on both regulatory barriers and market conditions. Presumably, heavily banked states will experience entry through acquisition, while de novo entry may dominate in others. Aggressive new branch entry in states dominated by small community banks may lead to increased failures of marginal operations.

A likely result of repealing McFadden and Douglas would be a shift of many large banks with interstate interests to national charters.
Ultimately, holding other things reasonably constant, CSBS predicts that the Treasury's proposal for geographic deregulation will result in a few very large multi-state operators and an increased number of small banks. The Treasury also anticipates this result. What will be reduced or eliminated is the number of middle tier banks, those with assets from $100 million to $2 billion. Unfortunately, these tend to be among the safest banks in our system.

Summary and Conclusion

I believe that any move toward full interstate branching should provide the following:

- time and opportunity to develop necessary regulatory safeguards;
- a local business entity with a level of management responsive to local concerns;
- preservation of state authority to limit or condition interstate entry;
- renewed commitment to improving the quality of "hands on" bank supervision;
- interstate branching linked to capital sufficiency (Tier I);
- affirmation of state authority to impose a franchise tax on a branch or bank is physically located in a state;
- barriers to market entry must be kept low enough to ensure competition;
- impacts on credit availability to small business and other sectors should be studied; and,
- states should have the opportunity to "opt in" on a limited, conditional or delayed basis.
Of all of the proposals I have reviewed to date, that which most nearly meets these goals is the "Wilmarth Proposal," advanced by the Conference of State Bank Supervisors. This proposal would apply recent experience with interstate banking to interstate branching. It would allow states to set certain conditions, limitations, and restrictions on interstate branching similar to those used to bring about interstate banking. This proposal allows states to perform their traditional role of experimenting with new approaches and techniques and would lead to an evolution to interstate branching. It proposes that states use a licensing procedure to address the tax and regulatory concerns.

The bad news is that the perfect model for interstate branching has not yet been developed. The good news is that there is no urgency to these proposals.

The "inevitability" of interstate branching is often invoked. If it is inevitable, as it may be, it will come whether you build it or not.

Thank you. I would be happy to answer any questions you might have.