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Interstate Banking in the West

On July 1, 1987, California and Washington joined six other states in the Twelfth Federal Reserve District in opening their doors to out-of-state banking organizations. The West is not alone in its hospitality, however, as all but ten states have adopted laws in recent years to allow the entry of out-of-state banking organizations.

Compared to other regions in the country, the West was relatively quick to permit interstate banking, in part because interstate banking organizations in the West already controlled a large share of banking assets. This *Letter* examines some of the factors that have spurred interstate banking, and describes the way in which interstate expansion is occurring with a particular emphasis on the "gold rush" in the West.

Restrictions on branching

The United States has not allowed nationwide branch banking since the demise of the second Bank of the United States in 1836. Nationally chartered banks were not even allowed to operate branch offices within their home states until the passage of the McFadden Act in 1927. With the 1933 amendment to that Act, national banks were granted the same branching privileges as those allowed state-chartered institutions by their state legislatures.

These acts equalized branching opportunities within a state, but allowed significant differences in branching laws among states. Some states permitted statewide branching, whereas others commonly prohibited branching altogether. In any case, the McFadden Act implicitly prohibited branching out of state regardless of a bank's charter.

To get around such restrictions on branching, multi-bank holding companies formed early in this century, enabling banking organizations to operate in locations where they could not set up branch offices. Eventually, however, Congress closed this loophole with the passage of the Douglas Amendment to the Bank Holding Company Act of 1956. This piece of legislation prevented banking organizations in one state from owning or controlling banks in other states unless those states permitted such out-of-state ownership.

Although the Douglas Amendment allowed "grandfathered" organizations to continue in operation, most chose to divest all but their largest bank subsidiary to avoid regulation by the Federal Reserve. Thus, until the 1980s, interstate expansion of banking organizations took place largely through such nonbank subsidiaries as finance companies, loan production offices, mortgage banking companies, and in certain instances, thrift institutions, which were not subject to branching restrictions.

State laws

The first state to allow entry of out-of-state banking organizations was Maine in 1975. Maine's law permitted the entry of banking organizations headquartered anywhere in the country, provided that Maine bank holding companies were allowed to enter the home states of out-of-state entrants to Maine. Massachusetts followed in 1982, but unlike Maine, Massachusetts adopted a bill that permitted the entry only of bank holding companies located in New England.

Many states did not pass interstate banking laws, however, until after the U.S. Supreme Court affirmed state control over interstate banking and bank entry in its *Northeast Bancorp vs. Board of Governors* decision in 1985. This decision affirmed states' rights to enact laws forming "regional compacts" that allow entry by banking organizations located only in selected states. This ruling, in effect, enabled states to bar the entry of the large money center banks located in New York, Illinois, and California. With this protection, states moved quickly to adopt some form of interstate banking. Many of

the new laws allow only regional interstate banking initially, and provide for nationwide entry at a later date.

In the West . . .

By contrast, most western states did not wait for the *Northeast Bancorp* decision to enact interstate banking laws. California, which passed its interstate banking law in September 1986, and Hawaii, which has yet to enact an interstate banking bill, are the exceptions. (Washington enacted a law in 1985 that did not take effect until July of this year.)

Most of these laws allow for regional interstate banking initially, with trigger dates for nationwide interstate banking in the future. For example, California will allow nationwide entry beginning on January 1, 1991. At the same time, each state's law defines its initial interstate region somewhat differently. The most restrictive is Idaho's law, which permits entry by bank holding companies located only in the six contiguous states. The laws enacted by California, Oregon, Nevada, and Utah all encompass a broader geographic area, but Nevada and Utah laws specifically exclude California bank holding companies from entering until the national trigger dates. Alaska, Arizona, and Washington, by contrast, already allow nationwide entry.

Why now?

States have had the authority to permit interstate banking at least since the passage of the Bank Holding Company Act of 1956. What has changed in recent years to make interstate banking seem so irresistible now? Perhaps the most important development has been the growing number of failing institutions that must be handled by banking and thrift regulators. Because many of these institutions cannot be absorbed by in-state organizations, regulators frequently have taken advantage of their authority to arrange acquisitions by out-of-state organizations.

Moreover, interstate banking may have become more attractive because the risks of undiversified portfolios have become all too apparent of late. For example, the troubles of agricultural banks in the Midwest and of energy lenders in Texas and Oklahoma are directly related to the lack of diversification. Finally, some states may have chosen to enact interstate banking laws as a means of pre-empting potential federal legislation that may turn out to be less favorable to the interests of those states' banking industries. By passing legislation now, the states have attempted to control the way in which interstate entry occurs.

In one sense, however, it may be misleading to look for explanations of interstate banking in sudden changes in state laws governing bank expansion. The formation of multi-state bank holding companies beginning in the early part of this century suggests that there always have been economic forces that make the operation of an interstate banking organization advantageous. For example, multi-state organizations always have afforded a relatively low-cost means of reducing credit risk through geographic diversification of the organization's portfolio. Moreover, interstate banking organizations provide a more economical means of collecting and disbursing out-of-state payments associated with the growth of interstate commerce and the increasing mobility of the U.S. population. Finally, improvements in information processing technology in the last 20 years also have made interstate banking organizations more economical.

Thus, the forces for change have been growing stronger over time. These forces have spurred the geographic expansion of nonbank subsidiaries of bank holding companies, as well as interest in supervisory mergers with out-of-state institutions that have failed.

Are we there yet?

In view of the flurry of legislative activity at the state level, one might expect a tremendous surge of interstate banking. There have been, in fact, a number of interstate acquisitions in the past two years as a result of new state laws. However, in a comprehensive article on interstate banking, Donald Savage suggests that assets held by bank holding companies outside their home states still account for only a relatively small proportion of total banking assets — six percent as of June 30, 1986. Savage also notes that interstate activity largely has been concentrated in areas which, because of the size of deposit bases or their growth, represent attractive markets. Clearly then, full nationwide interstate banking has not yet arrived.

The West, however, may be closer to full interstate banking than most other regions. Even before states began to change their laws to per-

mit out-of-state entry, a number of interstate banking organizations existed in the West and controlled over ten percent of the region's banking assets. Bank of California operates branches in California, Oregon, and Washington under a grandfather provision in the Federal Reserve Act in 1913. Multi-state organizations such as First Interstate Bancorp, which has banking subsidiaries in twelve western states, and First Security Corporation, which has subsidiaries in three states, were "grandfathered" under the Bank Holding Company Act of 1956. Other organizations such as BankAmerica and Moore Financial of Idaho have acquired out-of-state subsidiaries through purchases of failing institutions.

Following the enactment of state laws authorizing interstate acquisitions, western banks have increased their interstate presence and interstate banking organizations now control almost two-thirds of total assets. Because of the preponderance of regional compacts, western banks, like their counterparts elsewhere, have tended almost exclusively to acquire other banks within their own region.

Typically, the larger banks have sought to acquire medium-sized banks in major markets to establish a strong presence throughout the region. These acquisitions are creating so-called "superregionals." For example, Security Pacific, based in southern California with $58 billion in assets, has acquired or is seeking to acquire banks in northern California, Washington, Arizona, Oregon, and Nevada. U.S. Bancorp, based in Oregon with $9 billion in assets, is seeking to expand its operations in the Pacific Northwest through acquisitions in eastern and western Washington. Valley National of Arizona ($10 billion in assets) has acquired banks in Utah and California, thereby expanding its southwestern presence.

Big vs. small

Although out-of-region organizations also have acquired western banks, they usually acquire smaller institutions than those being bought by banks in the West. To a certain extent, this difference is due to the restrictions western states have placed on out-of-state entry. For example, only Alaska, Arizona, and (only very recently) Washington currently allow nationwide entry. Since most of the larger acquisition candidates in these three states have been snapped up by within-region organizations, only the smaller banks remain to be acquired by out-of-region organizations. The larger size of within-region acquisitions probably is due to a perception on the part of some of the larger western banks that rapid attainment of superregional stature is necessary to compete with the large money center banks once those banks are allowed to enter all western states.

In light of the trend toward superregionals, it is interesting that the market appears to be placing a premium on the purchase of larger banks. A recent survey of interstate acquisitions by Cates MergerWatch indicates that the larger banks (over $500 million in assets) sold for higher premiums (measured by purchase price to book value) than smaller institutions.

While a number of factors may explain this divergence, a recent *Letter* on acquisitions in banking found that increased share values associated with bank acquisitions were due largely to anticipated gains from geographic expansion and operating synergies available to the expanded banking organization, and *not* to anticipated increases in concentration and market power. Thus, the attractiveness of the larger banks in the West may arise from opportunities their acquisition offers to a within-region acquirer to operate a regional network with a significant presence in all the major markets.

Where to?

All of the changes in state laws and the acquisitions that have occurred under those laws still represent only a modest step in the direction of full nationwide banking. For now, the development of superregionals is dominating interstate banking in the West and elsewhere. Whether interstate banking will progress beyond regional banking in the near future will depend on how quickly the large money center banks are allowed to expand. It is clear, though, that bank holding companies are actively taking advantage of the opportunities given them and that economic forces will continue to push the U.S. banking system toward interstate banking.

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Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.
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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/21/87	Change from 10/14/87	Change from 10/22/86 Dollar	Change from 10/22/86 Percent[7]
Loans, Leases and Investments[1] [2]	207,684	610	3,300	1.6
Loans and Leases[1] [6]	183,490	366	– 103	0.0
Commercial and Industrial	51,097	98	328	0.6
Real estate	71,792	171	4,871	7.2
Loans to Individuals	36,850	– 57	– 4,431	– 10.7
Leases	5,423	18	– 167	– 2.9
U.S. Treasury and Agency Securities[2]	16,998	235	4,121	32.0
Other Securities[2]	7,196	9	– 719	– 9.0
Total Deposits	206,413	– 2,713	1,684	0.8
Demand Deposits	51,869	– 2,687	564	1.0
Demand Deposits Adjusted[3]	36,645	1,660	– 10,597	– 22.4
Other Transaction Balances[4]	19,937	– 159	2,223	12.5
Total Non-Transaction Balances[6]	134,608	134	– 1,102	– 0.8
Money Market Deposit Accounts—Total	43,988	– 553	– 2,228	– 4.8
Time Deposits in Amounts of $100,000 or more	31,323	267	– 2,505	– 7.4
Other Liabilities for Borrowed Money[5]	23,701	1,405	– 4,167	– 14.9

Two Week Averages of Daily Figures	Period ended 10/19/87	Period ended 10/5/87
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	61	0
Borrowings	22	158
Net free reserves (+)/Net borrowed(–)	39	– 157

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change