

Interstate Banking and Product-Line Freedom: Would Broader Powers Have Helped The Banks?

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The banking difficulties of the 1980s prompted Congress to enact the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Advocates of structural reform have criticized the FDICIA because it does not include broader interstate banking authority and product-line freedom. In this Article, Mr. Litan predicts the effect the absence of such reforms can be expected to have on the U.S. banking industry. The predictions are derived from counter-factual exercises in which the author measures the impact the reforms would have had on the banking industry of the 1980s had the reforms been enacted. These exercises suggest that broader interstate powers would be more effective than expanded product-line authority at reducing bank failure, but they also indicate that neither reform would significantly reduce the number of bank failures during the next several years. Nevertheless, it appears that broader interstate authority, coupled with broader product-line freedom subject to suitable safeguards, would strengthen the industry overall by mitigating the risks associated with banking and lowering the prices of financial services. As a result, Mr. Litan concludes that structural reform of the banking system should remain on the congressional agenda.

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Introduction

The banking legislation enacted in 1991, infelicitously named the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), was a major disappointment.¹ Although the Act provided a much-needed stiffening of regulatory discipline, Congress refused to include the Administration's so-called "structural" reforms that would have allowed banks to branch interstate, to engage in other financial activities, and to be owned by commercial enterprises.² The Administration tried to resurrect at least the interstate branching proposal in 1992, but at this writing it appears that Congress remains a long way from enacting any significant part of the structural reform agenda.

How much will the banks, and the nation as a whole, miss by not having the additional freedoms the Administration proposed? In its 1993 budget, the Administration claims the lost opportunities will prove quite costly, adding \$16 billion to government outlays for additional bank failure costs during the 1992-97 period.³ The budget provides no supporting documentation for this claim and the purpose of this Article is not to provide an alternative estimate.

Instead, my purpose is to identify the additional benefits interstate and product-line freedoms would bring to banks in the future by determining the degree to which banking difficulties in the 1980s can be attributed to the absence of these freedoms. If it can be shown that nationwide branching and affiliation with a broad range of non-banking enterprises would have reduced the number of banking failures and increased profitability of the banking industry as a whole, then by implication, the failure of Congress to address the structural issues in 1991 was a serious omission. Alternatively, if the geographic and product-line reforms would have made little difference to the U.S. banking performance during the past ten years, then the case for making those reforms in the future would be considerably weaker.

Part I of the Article provides a brief background on the nature of and reasons for the recent difficulties in the U.S. banking industry. Part II examines whether unrestricted geographic freedom for the banking industry in the 1980s would have increased their profitability through cost reductions or geographic diversification. Part III conducts a similar analysis for broader product-line powers. Finally, Part IV explores alternative strategies for future policy-making prompted by each of the hypothetical exercises.

The Article concludes that broader geographic flexibility would be more effective at reducing bank failure than would expanded product-line authority.

1. Pub. L. No. 102-242, 105 Stat. 2236 (1991) (codified in scattered sections of 12 U.S.C.).

2. The Administration's proposal was presented and justified in U.S. DEP'T OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS (1991)[hereinafter MODERNIZING THE FINANCIAL SYSTEM].

3. THE 1993 BUDGET OF THE UNITED STATES GOVERNMENT, pt. 1, at 13.

However, given the nature of the economic forces that contributed to the rising bank failure rate of the 1980s, many smaller banks would have failed during the decade even had they enjoyed total geographic and product-line freedom. The most important benefits of broader geographic and product-line powers would have accrued to those banking organizations *not* currently in trouble. Although structural reforms would not have averted the bulk of 1980s bank failures, they might have mitigated the problem. Structural reform of banking, therefore, especially broader financing services, should remain an important item on a future congressional agenda.

I. Recent Banking Problems

Before turning to the counter-factual exercises directly, it is useful briefly to summarize certain key facts about the way U.S. banks actually performed in the 1980s and early 1990s, including key Congressional responses to those difficulties enacted in 1991.

The United States banking industry during the past decade presents a paradox. On the one hand, most failures and the costs they imposed on the industry's insurer, the Federal Deposit Insurance Corporation (FDIC), were concentrated among smaller banks. A 1991 study by the House Banking Committee, for example, found that 75 percent of the bank failure costs that the FDIC incurred since 1985 were due to the insolvencies of banks with less than \$1 billion in assets.⁴ Similarly, a report I co-authored for the Financial Institutions Subcommittee of this same Committee found that of the nearly 900 bank failures between 1985 and 1989, just nine were of banks with more than \$1 billion in assets and only 18 had assets above \$500 million. The larger banks, of course, accounted for a much larger fraction of the total \$15.7 billion in failure resolution costs during this period. Still, the failures of the nine largest banks cost just \$5.7 billion, or a little more than one-third of the total.⁵

The paradox arises because, on the other hand, bank profits suffered in the 1980s most not among the smallest banks, but among the largest. Indeed, Figure 1 illustrates that the most profitable banks, measured by return on equity, were those in the "middle range," the roughly 3000 banks with assets between \$100 million and \$10 billion. Behind those were the approximately 9000 banks with less than \$100 million in assets. And ranking at the very bottom in terms of

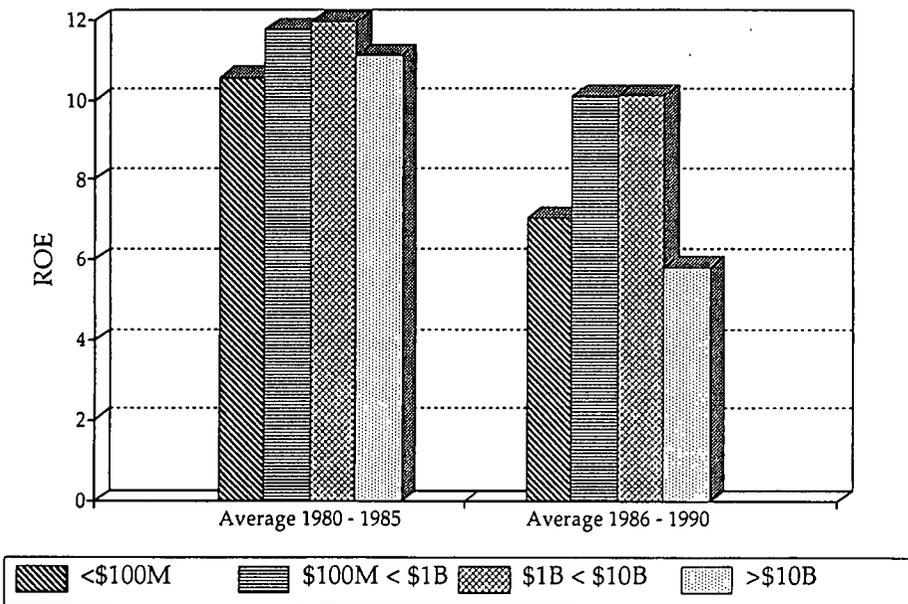
4. This finding is reported in Kenneth H. Bacon, *Panel Criticizes Comptroller in Bank Failures*, WALL ST. J., Sept. 9, 1991, at A3.

5. Calculated from HOUSE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REG. AND INS. OF THE COMM. ON BANKING, FINANCE, AND URBAN AFFAIRS, 101ST CONG., 2D SESS., *BANKING INDUSTRY IN TURMOIL: A REPORT ON THE CONDITION OF THE U.S. BANKING INDUSTRY AND THE BANK INSURANCE FUND*, tbl. A-9 (Comm. Print 1990) (James Barth, R. Dan Brumbaugh, Jr., & Robert E. Litan)[hereinafter *BANKING INDUSTRY IN TURMOIL*].

profitability were the nation's largest banks, or those with assets above \$10 billion.

What accounts for the fact that so many failed banks were so small while poor profitability plagued the largest banks? Failures were concentrated among smaller institutions (generally below \$1 billion in assets) located in states that were hit by the sudden and severe declines in oil and agricultural prices in the 1980s. Thus, between 1985 and 1989, failures in just three states heavily dependent on energy and/or agriculture (Louisiana, Oklahoma, and Texas) accounted for 57 percent of the number of all failed banks during this period and 81 percent of total bank resolution costs.⁶ Significantly, until late in the decade and after much of the damage had already been done, all of these states also limited the branching authority of their banks and did not permit out-of-state bank holding companies to acquire their home-state institutions. Since the banks in these states therefore were unable or unwilling to diversify either their deposit sources or their loan portfolios, they were dragged down by the declining fortunes of their customers.

Figure 1
Bank Return on Equity by Size



Source: Barth, Brumbaugh and Litan, *Banking Industry in Turmoil: A Report on the Condition of the U.S. Banking Industry and the Bank Insurance Fund*, 1990.

6. Calculated from *BANKING INDUSTRY IN TURMOIL*, *supra* note 5, at app. G.

In contrast, the poor profitability of larger banks during the 1980s was primarily attributable to their *loss* of customers, principally high-quality corporate borrowers, who found it cheaper, for a variety of reasons, to borrow directly through the securities markets rather than through banks. Large banks compensated for this loss in their low-risk customer base by chasing high-risk lending, initially in the form of loans to less-developed countries (LDCs) and later in commercial real estate and highly-leveraged transactions (HLTs). When these high risks proved to be even riskier than expected, loan losses mounted and large banks suffered a sharp erosion in their profitability, as shown in Figure 1. Smaller banks did not suffer the same fate largely because they did not lose *their* customers—namely, small-to-medium sized businesses and individuals—who were not in a position to access the securities markets as could the larger corporations.

Nonetheless, both the small and medium sized banks still posted disappointing returns on equity during the 1980s. The best-performing group—the middle-size banks—earned an average of only 11% on equity during the decade, less than the 12% average return on equity for the entire banking industry in the 1970s and the 13% return on equity earned by manufacturing companies during the 1980s.⁷ These statistics suggest that all banks were negatively affected by certain common factors.

Increased competition reduced the profitability of all banks. Consider first the cost of bank liabilities, principally deposits. Following the deregulation of deposit interest rate controls in the early 1980s, banks of all sizes were forced by competition from mutual funds and insurance companies to pay more for their funds. In 1980, banks paid an average of three percentage points (or 300 basis points, each basis point representing .01%) *less* for their deposits than the six-month interest rate on Treasury bills. By 1985, several years after bank deposit interest rates had been effectively deregulated, banks' funding advantage relative to Treasury instruments had completely disappeared.⁸

Banks also were forced to accept lower profit margins, or spreads, on their bread-and-butter asset-side lending activities because of two major types of "securitization," the replacement of banks by securities instruments and markets as devices for transferring funds from savers to investors (or lenders to borrowers).

Large banks suffered the most from the first type of securitization, which saw large corporate customers that used to borrow from banks turn gradually to issuing commercial paper (unsecured short-term promissory notes that are

7. Banking returns for the 1980s are from BANKING INDUSTRY IN TURMOIL, *supra* note 5, at app. C; banking data for the 1970s are calculated from the BUREAU OF THE CENSUS, U.S. DEP'T OF COM., STAT. ABSTRACT OF THE U.S., various years; and manufacturing data are calculated from THE ECON. REP. OF THE PRESIDENT 391 (1991).

8. See ROBERT E. LITAN, THE REVOLUTION IN U.S. FINANCE 11 (1991).

readily traded on the open market). A much broader range of banks, however, have felt the sting of the second form of securitization: Wall Street's transformation of formerly illiquid loans into marketable securities collateralized by those loans.

The second type of securitization was launched in the early 1970s by the federal housing agencies, which guaranteed or "credit enhanced" pools of residential mortgage loans. Since then, roughly \$1 trillion in mortgages, or more than 35% of the total outstanding, have been transformed into securities. In recent years, consumer installment and credit card loans also have been turned into asset-backed securities, totalling about \$80 billion at year end 1991.⁹

The mass production of credit has become the Trojan horse of the American banking system. While the liquefaction of credit has made it easier for banks (and thrifts) to shed their assets when they want to, it also has allowed pension funds, insurance companies, and mutual funds to enter the market for formerly illiquid credits. This has undermined much of what banks alone used to get compensated for: analyzing nonstandardized credits and then holding them in portfolio. As a result, yields on securitizable loans have been compressed by anywhere from 30 to 100 basis points on residential mortgages and by an unknown amount on consumer loans.¹⁰

In short, during the 1980s similar competitive forces hit all banks and lowered distribution of profits across-the-board. By itself, however, this effect would not have attracted significant attention or concern from policymakers, few of whom have been especially protective of bank profits.

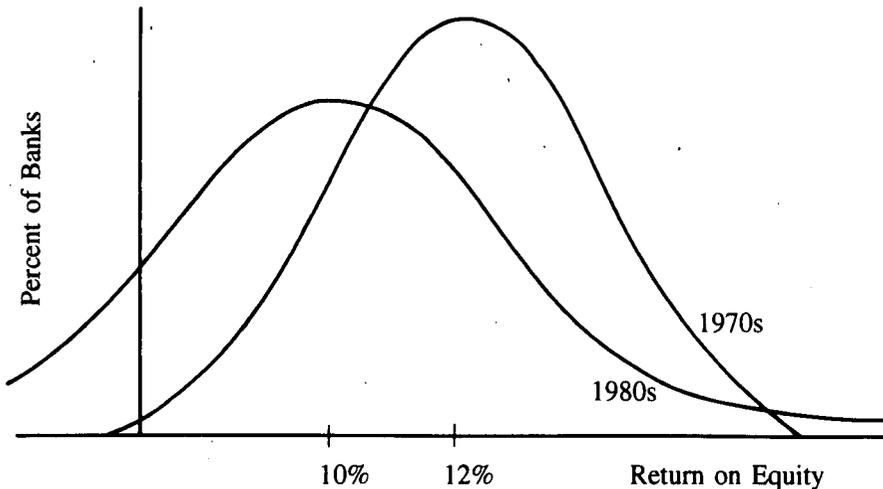
The central reason that bank industry performance hit the political radar screen during the 1980s was that the left *tail* of the distribution of bank profits (or the percentage of banks that lost money and, in the worst case, became insolvent) became thicker and fatter. Thus, whereas in the 1970s virtually no banks failed and relatively few lost money, by the end of the 1980s, roughly 10% of all banks that started in the decade had failed and an additional 10% were still losing money.¹¹

9. Data from various issues of the *Federal Reserve Bulletin* (on file with author).

10. The 30 basis point estimate is found in PATRIC HENDERSHOTT & JAMES D. SHILLING, *THE IMPACT OF THE AGENCIES ON CONVENTIONAL FIXED-RATE MORTGAGE YIELDS* 10 (National Bureau of Economic Research Working Paper No. 2646, 1988). Others claim the effect of securitization on residential mortgage rates is as large as 100 basis points. See JAMES ROSENTHAL & JUAN OCAMPO, *SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE* 12 (1988).

11. See, e.g., FDIC QUARTERLY BANKING PROFILE, various issues. For the number of failures, see 1990 FDIC ANNUAL REPORT.

Figure 2
 Illustrative Changes in the Distribution of
 Bank Performance (1970s vs. 1980s).



The relevant distinction is illustrated in Figure 2. The figure assumes for illustrative purposes that bank profits were normally distributed in both the 1970s and 1980s. In particular, the x-axis shows that during the 1970s bank profits averaged 12% on equity and that a very low percentage of all banks lost money. In contrast, the 1980s saw both a leftward shift of the entire distribution—down to an average return of 10% on equity—but also a flattening of the entire distribution such that a substantial percentage of banks lost money and/or failed.

A challenge addressed in the rest of this Article is to determine to what extent this clear alteration in the *shape* of the distribution of bank profitability and performance could have been prevented had banks and their holding companies been given broader geographic and product-line freedom before the 1980s. To a lesser extent, the Article considers the more obvious positive effect these changes in public policy would have had on the shift in the *location* of that distribution.

Congress did little during the decade to address the fundamental changes in the banking industry caused by market forces. In part, this was the industry's own fault because it did not (and still does not) speak with one voice. Larger banks believed that the erosion in their profitability could be halted only if they were given the freedom to diversify more broadly their places and sources of business. Smaller banks generally supported greater product-line freedom, but

strongly opposed interstate banking and branching as a threat to their viability and independence.

In the end, Congress gave neither side what it wanted. Instead, in 1991 Congress rejected the comprehensive financial services reform package that the Bush Administration proposed. The package would have authorized nationwide banking (ownership by holding companies of banks in any state) and branching, freedom for bank holding companies to engage in any financial activity, and ownership of banks by any type of organization, financial or non-financial.¹² Instead, Congress opted for a narrow bill that granted the FDIC authority to borrow up to \$30 billion to pay for future bank failures and provided for a new mandatory system of "early intervention" by regulators to discipline weak banks.¹³

By early 1992, it was unclear whether the additional funds for the FDIC would last more than a few years. At the beginning of the year, the FDIC reported a sharp increase in the volume of assets at "problem banks"—institutions receiving one of the two worst ratings (of five possible ratings) by bank examiners—to more than \$600 billion, from approximately \$400 billion the preceding year.¹⁴ Although the \$30 billion in borrowing authority plus annual revenues from deposit insurance premiums of \$6-7 billion may enable the FDIC to cover losses from failures in this group of banks, the agency is running a risk of having insufficient funds again if bank failures mount significantly in the months and years ahead.

II. Rerunning History With Interstate Banking

Had banks been allowed to form nationwide interstate networks or even single banks many years ago, there is little doubt that today the banking industry would contain several—perhaps ten or more—nationwide banking organizations. Many other regional banks collectively would hold a sizeable share of the national market. An uncertain number of small banks would remain, although some portion of those located in Texas and Oklahoma probably would have failed during the 1980s in any event.

12. See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 1. Whereas current law generally prohibits banks from establishing separate branches in multiple states, it permits bank holding companies to own separately incorporated and chartered banks in different states that permit such interstate operations. Most large banks contend that it would be more efficient to operate interstate through a branch network than through multi-state holding companies.

13. The legislation allowed the FDIC to borrow up to \$70 billion, but only \$30 billion of this amount is for so-called permanent losses. The other \$40 billion is to cover the cost of temporarily financing assets of failed banks before they are sold. See, e.g., Robert M. Garsson, *Taylor Blasts Proposal to Phase in FDIC Recap*, AM. BANKER, Nov. 26, 1991, at 1.

14. See, e.g., Barth, *No Letup in Bank Woes*, AM. BANKER, Mar. 23, 1992, at 6.

Advocates of broader geographic freedom for banks claim it would produce a more efficient and better diversified banking structure. What does the evidence actually suggest?

It is important to specify the starting point for the proposed counterfactual clean slate. Despite the restrictions, there was a significant movement during the 1980s toward broader geographic operations, but one that percolated up from the collective actions of most states rather than one mandated from the top down by the federal government. Specifically, under the Bank Holding Company Act of 1956 (later amended in 1970), states have had the freedom to permit entry by bank holding companies (BHCs) headquartered out-of-state.¹⁵ In the 1980s, many states began exercising that authority first in the form of reciprocal authority granted to other states and then later, on an unrestricted nationwide basis. Currently, almost all states allow some form of interstate bank entry and over 30 states permit entry by BHCs from anywhere in the country.¹⁶

Nevertheless, nationwide freedom for all BHCs still has not been obtained. Moreover, no state currently permits interstate branching by banks from other states. The counterfactual whose implications are explored below seeks to compare an industry that was partially deregulated on a geographic basis during the 1980s with one that would have been totally unregulated in this dimension.

A. *Cost Savings Are Probably Less Than Advertised*

In 1990, U.S. banks spent \$115 billion on noninterest expenses.¹⁷ How much lower that total would have been had a more streamlined banking structure existed throughout the 1980s depends on who one asks. Most economists would probably say the potential savings would not have been that large based on a series of studies that find economies of scale in banking to be exhausted at relatively low size levels, in the neighborhood of \$100 million in assets and generally much less than \$1 billion in assets.¹⁸ These studies are suspect because they rely on data bases that exclude banks with assets above \$1 billion. Nevertheless, few econometric studies using more expansive sources of data find economies of scale much above several billion dollars in assets.¹⁹

15. See BANK HOLDING ACT OF 1956, 12 U.S.C. §§ 1841-1843, 1846, 1849.

16. See Gerald A. Hanweck, Interstate Banking, Bank Expansion, and Valuation, Address at the Fed. Reserve Bank of St. Louis 15th Ann. Econ. Policy Conf. 10 (Oct. 18, 1990) (transcript on file with author).

17. FDIC QUARTERLY BANKING PROFILE, Fourth Quarter 1990 at 5, tbl. II, col. 1.

18. For an excellent summary of the literature, see Jeffrey A. Clark, *Economies of Scale and Scope at Depository Financial Institutions: A Review of the Literature*, FED. RESERVE BANK OF KANSAS CITY ECON. REV., Sept.-Oct. 1988, at 16-33.

19. See, e.g., Athanasios G. Noulas et al., *Returns to Scale and Input Substitution for Large U.S. Banks*, J. MONEY, CREDIT & BANKING, Feb. 1990, at 94-108 (economies at \$1-3 billion in assets for 1986 data); William C. Hunter & Stephen G. Timme, *Technical Change, Organizational Form, and the Structure of Bank Production*, J. MONEY, CREDIT & BANKING, May 1986, at 152-66. More recently Hunter and

In contrast, banking analysts and consultants seem to be much more sanguine about the opportunities for economies of scale. Perhaps best known is the estimate by Lowell Bryan, the director of the banking group at McKinsey Company, who has estimated that nationwide branching could save the banking system as much as \$14 billion in annual costs. The consolidation of the 127 largest banks into ten to fifteen banks would provide \$8 billion in savings, the consolidation of many small banks would produce another \$4 billion in savings, and the collapse of the corporations of existing holding companies into single banks with multiple branches would yield an additional \$2 billion.²⁰ Former *American Banker* columnist and now consultant Sanford Rose is even more optimistic, projecting that a consolidation of all 12,000 banks today into just 153 banks—assuming 3 banks in each state and an extra 3 for New York—would save the industry \$23 billion in noninterest banking expenses.²¹

These estimates, however, have limited relevance to the counterfactual explored here; namely, how much better off would the banking industry *actually* have been had it enjoyed unrestricted geographic freedom in the 1980s. The Bryan and Rose studies look to the end results of consolidation. They do not consider the time it would take to achieve these results. Both sets of estimates assume a radical degree of consolidation, which would not have occurred had U.S. banks been given their geographic freedom in the 1970s or perhaps even as early as the 1960s. There simply would not have been sufficient time for mergers and attrition to have reduced the more than 14,000 banks in the system to any number even close to the low numbers of banks on which the Bryan and Rose estimates rest.

The Bryan and Rose estimates get more interesting, at least for purposes of my counterfactual analysis, if it is assumed that the McFadden and Bank Holding Company Acts²² had never been enacted—so that the interstate movement launched by Bank of America in the 1920s would never have been thwarted legislatively. In that event, it is certainly conceivable that the banking system in the United States today would be as concentrated as the Japanese or European systems, with perhaps no more than 100 banks controlling virtually

Timme have found potential economies at up to \$25 billion in asset size. See William C. Hunter & Stephen G. Timme, *Some Evidence on the Impact of Quasi-Fixed Inputs on Bank Scale Economy Estimates*, FED. RESERVE BANK OF ATLANTA ECON. REV., May-June 1991, at 12-20. This result is generally consistent with that reached (by different methods) by Sherrill Shafer and Edmond David, who find economies at up to \$37 billion in asset size. See SHERRILL SHAFER & EDMOND DAVID, *ECONOMIES OF SUPERSCALE AND INTERSTATE EXPANSION* (Fed. Reserve Bank of New York, Nov. 1986.)

20. See Bill Atkinson, *Cost Reduction Under Reforms Widely Debated*, AM. BANKER, Apr. 19, 1991, at 8.

21. See Sanford Rose, *Rx for a Safer and Sounder Banking Sector*, AM. BANKER, May 14, 1991, at 1, 4, and 17.

22. Bank Holding Company Act, 12 U.S.C. § 1841 (1982), 26 U.S.C. § 1101 (1982); Bank Holding Company Act Amendments of 1970, 12 U.S.C. §§ 1841, 1843, 1849 (1982), 31 U.S.C. §§ 5111, 5112 (1982); McFadden Act, 12 U.S.C. §§ 36, 332 (1982).

all of the nation's banking assets. Still, would the cost savings be as large as Bryan and Rose suggest?

Given the paucity of evidence of significant economies of scale at larger asset sizes, let us assume for the sake of argument that these economies can be realized at least up to \$1 billion in assets. Under this assumption, we can calculate the cost savings of moving all of the 9,500 smallest banks as of mid-1990, or those with less than \$100 million in assets, into the \$100 million to \$1 billion asset size range.²³ For this purpose, make the additional assumption that such a transfer would permit all of the banks in the former category to have earned the same return on assets (ROA) as the banks in the latter category. Between 1985 and 1989, the difference in ROAs between these two groups of banks averaged 0.138% (0.582% for the small banks and 0.72% for the mid-size banks), which when applied to the \$366 billion in assets held by the small banks at year-end 1989 would have yielded only \$500 million in annual savings. It is certainly conceivable, of course, that economies are available at larger bank sizes, but this is not evident from the ROA data, which show that banks in the \$1-10 billion size category actually earned less on their equity than those in the \$100 million-\$1 billion size grouping.

A major reason for viewing some of the claims of large cost savings for larger banks with skepticism is the tendency by some to confuse the savings generated by within-market mergers between direct competitors with those generated by market-extension bank consolidations involving banks initially in different geographic locations. When two large banks in the same market merge, such as Chemical Bank and Manufacturers Hanover, it is likely that there will be at least some cost savings from closing suddenly redundant branches.²⁴ Such savings are possible even though economies of scale may be difficult to realize at larger banks generally because *at the individual branch level* each large bank party to a merger may not currently be operating at an efficient level, given the pre-merger level of competition. By leading to the closure of competitive offices, often across the street, such within-market mergers may be able to produce efficiencies at many of these branches.

In contrast, the market-extension merger, such as the NCNB and C&S/Sovran combination that has produced Nations Bank, should provide far fewer opportunities for eliminating redundancies. Yet to have produced a nationwide banking system in the 1980s, the United States would have had to have experi-

23. Calculations drawn from BANKING INDUSTRY IN TURMOIL, *supra* note 5, at app. C.

24. In announcing the merger of these banks, officials of the organizations claimed annual cost savings of \$650 million. See Steven Lipin, *Chemical and Hanover Agree to Merge; \$650 Million in Annual Savings Forecast*, AM. BANKER, July 16, 1991, at 1. Although some analysts greeted the estimation with skepticism, it is noteworthy that when Chemical Bank issued over \$1 billion in new stock in early 1992 to more fully capitalize the combined institution, the market absorbed the new offering with little trouble, suggesting that investors generally believed managers' claims that the combined entity would be able to achieve significant cost savings.

enced many more market-extension than within-market mergers. Accordingly, it is inappropriate to extrapolate cost savings from "within-market" mergers (such as the Chemical-Manny Hanny marriage) to the market-extension mergers which would have been characteristic of pre-1980 merger activity had nationwide banking been allowed and which will be characteristic of most large bank mergers in the future.²⁵

It also is worth adding some caution to claims that unrestricted branching authority would have generated significant cost savings from the collapse of multi-bank holding companies into single large banks. On the surface, this claim is quite reasonable. By converting to a single branch network from a multi-bank holding company, banking organizations can save seven-figure sums in lower attorney and accountant expenses and in reduced director fees. Nevertheless, banking organizations such as Banc One have a different, and potentially more profitable, philosophy. Having local boards of directors may put each bank better in touch with local business conditions and borrowers. And it may be easier to recruit top-flight personnel to individual banks by giving them bank officer titles as opposed to branch manager (and lesser titled) positions. In combination, both factors may enable multi-bank holding companies better to avoid the lending mistakes that, as Figure 1 reflects, characterized larger banks as a group in the 1980s, and whose costs could easily outweigh any cost savings from eliminating redundant lawyers, accountants, and directors.

Finally, not all of any cost savings that would have been generated in a legal regime allowing complete geographic freedom for banks would have passed directly to the banks' bottom line. In fully competitive markets, cost reductions get passed on to consumers. The amount of pass-through depends principally on the shape of the cost curve in the relevant ranges of output. With flat cost curves (implying constant marginal costs and thus no economies of scale), the pass-through is 100%. With upward-sloping cost curves, consumers get something less than 100% of the cost reduction. Without extensive empirical data, it is impossible to know which cost conditions prevailed for which banks. Suffice it to say that there are no guarantees that any cost savings would be fully reflected in banks' profitability.

In fact, it is even possible that complete removal of all geographic restrictions much earlier would have induced so much more competition among banks nationwide that overall bank profitability would have been *lower* than it actually was. This appears to be the case with intrastate banking restrictions (or provisions limiting the ability of banks to branch within their own state). Control-

25. Indeed, one recent study by economists at the Federal Reserve Board suggests that cost savings from both types of mergers—within-market and market extension—may be illusory. The study found in a sample of 134 mergers completed during the 1980s that no more than one in ten merged institutions achieved better profitability than independent banks. Richard Layne, *Does Merging Pay? Fed Studies Say No*, AM. BANKER, Feb. 12, 1992, at 1.

ling for various relevant factors, bank profits have been found to be lower in states without these restrictions than in states with them, a result due to the pro-competitive impact of geographic freedom within states.²⁶ While the removal of interstate restrictions may not be as procompetitive, its effects presumably would work in the same direction.

In sum, it is doubtful that whatever cost savings broader geographic freedom would have brought to the banking industry would have shown up in materially higher profits for the industry. And what gains would have existed would have been manifested primarily in a rightward (positive) shift of the profitability distribution of banks shown in Figure 2 and to a much lesser extent in the reduction of the percentage of banks in the left, negative-return end of the distribution. That is, while it is conceivable, but by no means clear, that the typical bank would have been more profitable, it is highly doubtful that for *reasons of cost savings alone* the many small banks that failed in the 1980s would have avoided failure simply by being joined to entities with somewhat lower costs. After all, the resolution costs of the typical failed bank during the 1980s exceeded 10% of assets (or 1200 basis points),²⁷ a figure that would not have been offset by even many years of substantial cost savings of, say, 15-20 basis points per year.

B. *Diversification Would Have Offered Greater Benefits*

The diversification argument is based on standard portfolio theory. Banks that are confined to a single or a few locations are forced to put all their lending eggs into a single geographic basket, which is affected by the economic fortunes of that locale. In contrast, nationwide banking organizations would be able to diversify their lending and deposit risks throughout the nation.

One of the statistics most commonly cited to illustrate the dangers of operating in a local market is the fact that nine out of the top ten banking organizations in Texas either failed or were reorganized during the 1980s.²⁸ It is doubtful that this would have been the case had all nine been part of nationwide banking networks.

Sanford Rose provides some interesting analytical evidence of the potential benefits of geographic diversification. Using data from multi-state holding companies during 1982-89, Rose reports that regionally diversified operations had 28% lower variance in loan losses over time than single-state banking organizations. He computes that this would have translated into an increase in average return on equity (ROE) of these banks of 4.4 percentage points, a far

26. See Herbert Baer et al., *Geographic Deregulation in Banking and the Public Interest*, ISSUES IN BANK REG., Spring 1988, at 10-17.

27. See BANKING INDUSTRY IN TURMOIL, *supra* note 5, at 63-66.

28. See MODERNIZING THE FINANCIAL SYSTEM, *supra* note 2, at 5.

more significant gain than the 1.7 percentage point improvement in the ROE from his estimated cost savings.²⁹

Although regional diversification could have increased the ROE for banks that practiced it, it is simplistic to assume that many of the banks that actually failed during the decade would have used interstate banking. The banking giants that in recent years have been putting together interstate operations have generally done so by purchasing medium to larger sized banks, or institutions with over \$1 billion in assets. As a result, it is likely that relatively few of the banks below \$1 billion in asset size—or most of the banks that actually failed—would have been taken over by or involved in interstate banking operations had unrestricted geographic authority been granted.

If U.S. banks had been free to cross state lines much earlier, the lower number and costs of bank failures in the 1980s would have been offset, to some extent, by higher numbers of failures and costs in the preceding decades when, in fact, virtually no failures occurred. The formation of nationwide banking networks would have intensified competition in geographic markets throughout the country, thereby triggering the collapse of those banks that were unable to join a network.

In addition, it can be argued that banks nevertheless have had significant opportunities to improve the geographic diversification of their lending operations by opening loan production offices (LPOs): locations from which out-of-state banks are allowed to originate loans but not to accept deposits. In fact, large banks reported a 64% increase in their LPOs between 1983 and 1988, from 202 to 332, which should have allowed many banks to diversify their lending risks to at least some extent.³⁰ It would appear, therefore, that the diversification benefits of interstate branching and banking rights relative to existing law are not nearly as large as Rose and others have claimed.

This critique, however, ignores several important factors. For one thing, the lawfulness of LPOs was not clearly established until the mid-1970s, so banks in this counterfactual exercise could not have taken advantage of the device any earlier. In addition, while LPOs afford banks the ability to diversify their loans, they provide no opportunities to do the same for deposits. This limitation helps explain why Continental Illinois Bank in the early 1980s was so highly dependent on “hot money” (large uninsured CDs) and thus highly susceptible to a run.

Most importantly, LPOs tend to be used overwhelmingly by larger banks and then principally for making large dollar loans to corporate customers of their lead (or home state) banks. While this is understandable—it is difficult

29. The improvement in ROE comes about because Rose assumes that with 28% less risk in earnings, the banking industry would need 28% less capital. With a capital base lowered by this amount, the same level of earnings would raise ROE by almost 39%. See Rose, *supra* note 21, at 4.

30. See Hanweck, *supra* note 16.

for out-of-state banks with no deposit-taking abilities to attract lending business of locally based customers—it means that the diversification benefits of LPOs are necessarily limited.

There is some doubt whether a banking system predominantly made up of large interstate banks or bank holding companies would have fared any better with opportunities for geographic diversification. As Figure 1 has demonstrated, the nation's largest banks tended to have the largest loan losses. These losses came about primarily because the largest banks lost their safest borrowers to the securities markets—a trend that would have existed even in an environment of nationwide interstate banking.

Nevertheless, it is possible to imagine a scenario in which interstate banks would have avoided many of the bad decisions which large banks made in the 1980s. It is at least plausible that had the nation's largest banks been preoccupied in the 1970s and early 1980s with fleshing out their interstate networks they would not have been so tempted to engage heavily in LDC lending. And if that were the case, then arguably after the LDC loans turned sour, these same banks would not later have been so tempted to double their bets with commercial real estate and HLT lending. Similarly, if the nation's largest banks had been healthier they would have enjoyed higher credit ratings and confidence among depositors that would have allowed them to attract funds at lower cost. As a result, fewer blue-chip corporate borrowers would have deserted banks for the securities markets. Thus the need or desire on the part of these banks for riskier investments would have been reduced.

What if nationwide interstate authority had been granted for many decades so that the largest banks had already assembled their nationwide networks before 1980? In that event, these banks would not have been preoccupied with anything else. Going into the period of heavy LDC lending, Citibank, Chase, and other large institutions would have behaved as the large European and Japanese banks did, making some LDC loans, but not betting too heavily on LDC debt. Of course, a counter-argument can be made that with a banking system dominated by relatively few, large institutions, the federal authorities would have had an easier time twisting the arms of fewer banks to “recycle” the large petrodollar surpluses of the OPEC countries to the energy-poor LDCs—the same countries (with few exceptions) that later effectively defaulted on at least some of their bank debt.

Whatever the benefits of interstate banking freedom, those banks joining interstate networks probably would have experienced greater returns than the smaller banks and would have been healthier in the long run. It is likely that several of the regional institutions which recently failed or are in trouble—Southeast Bank of Miami, the Bank of New England, MidAtlantic of New Jersey, First RepublicBank, and Mcorp Banks of Texas—would have been bought by larger institutions and thus would not have suffered the same fate.

In contrast, it is difficult to believe that the hundreds of smaller banks in Texas and other states that failed during the 1980s would have been bought out by larger institutions and thus avoided their demise.

Had nationwide banking been authorized many decades ago, then the projections for the failure rates of smaller banks would have looked more optimistic. Sufficient time would have allowed a food chain effect to develop: medium-size banks swallowing many smaller ones and larger banks swallowing medium-size banks. If, at the end of the chain, interstate operations resulted, then perhaps hundreds of small bank failures during the 1980s could have been avoided.

III. Rerunning History With Broader Product-Line Freedom

On the surface, broader activity authority for banking organizations—including the ability to sell and underwrite securities and insurance, to sell real estate, and to engage in any other financial activities—during the 1980s and earlier would have responded to at least one of the central problems that banks faced during the decade: a loss of their customers to other financial service providers. But here, too, some deeper analysis suggests that the likely reality is considerably more complicated. To the extent that such diversification opportunities would have been beneficial, the major gains probably would have been captured by consumers of financial services and not by their providers. More ominously, product-line freedom without appropriate safeguards to have separated the banking and non-banking operations could have led to even greater losses for the bank insurance fund and more widespread distress throughout the financial services industry.

Indeed, those dangers suggest that it is critical to define at the outset the level at which broader powers would have been granted: directly at the bank level, which many states in fact already have permitted for state-chartered banks, or only at the holding company level. In the former case, any benefits from activity diversification would have accrued directly to the banks, whereas in the latter case, the benefits would have flowed just to the holding companies and only then to the subsidiary banks if the holding companies downstreamed any earnings. In addition, and perhaps more importantly, the incentive effects of granting broader activity authority could differ between the bank and holding company levels. As discussed below, had troubled banks in the 1980s been allowed more activity freedom directly, it is possible, if not likely, that they would have acted like many of the deregulated thrifts during the same period, who abused their new activity authority. It is conceivable that the incentives for risk-taking would not have been as great had the activity freedom been granted only for bank holding companies.

In any event, as with interstate banking, it is dubious whether broader activity freedom, either at the bank or holding company levels, would have prevented sizeable numbers of smaller bank failures. Under any realistic set of assumptions, the cumulative losses at these smaller banks were significantly greater than any cumulative gains that could have been realized from selling insurance, real estate, or securities.

The interesting question, therefore, is the extent to which broader activity authority would have benefitted the *larger* banks and holding companies, or those organizations that have been most active in pressing Congress for so-called financial structure reform. In particular, would the benefits from these activities have been sufficient to have compensated these banks for the loss of their traditional customers? And, if so, would these benefits have deterred the banks from seeking out the riskier forms of lending that ultimately got them in so much trouble?

To answer these questions, it is important to identify exactly how additional activity authority could have been beneficial. One way, of course, is by providing banks with opportunities to earn greater returns, at lower risk, than they were earning from their traditional activities. When I examined this issue several years ago, investment banking—where the large firms in particular had ROEs averaging more than 20%—appeared to be a prime candidate for profitable bank entry.³¹ Since then, of course, the profitability of the Wall Street securities firms has been both up (in 1991, for example) and down (after the October 1987 stock market crash). But even so, it is likely that certain areas of investment banking, off limits to banks until very recently, could have been profitably exploited by several of the largest banks.

The top of my list would not include traditional equity and debt underwriting, on which profit margins generally were quite thin during the 1980s, but instead, fees from the securitization of residential mortgages, an activity dominated during the decade by Salomon Brothers and First Boston. It naturally has frustrated banks that, at least until recently, they could not securitize the raw material they originated, namely their loans. While credit must be given to Salomon, First Boston, and others for the financial engineering that went into creating the mortgage-backed security and other asset-backed instruments, it seems reasonable to assume that banks such as Citibank, Chase, and others would have been able to profit from the same activities had they been authorized to do so. The result would have been at least a modest improvement in the financial condition of each of these banks, although not so much as to have rescued them from their current difficulties.

31. See ROBERT E. LITAN, WHAT SHOULD BANKS DO? 64 (1987).

Consider, for example, the following hypothetical. During the 1980s, Salomon Brothers earned a total of \$3.5 billion in after-tax profit.³² Although I have no information about how much of that total was generated by fees and underwriting profits in the securitization of residential mortgages, I do not believe it unreasonable to assume that \$500 million was so earned. Suppose that Citicorp had been able to earn half of this, or \$250 million, and then retained half, or \$125 million (paying out the other half in dividends); also throw in another \$125 million (after dividends) for other underwriting profits. Today, Citicorp's book value would stand at \$8.25 billion rather than \$8 billion, an improvement to be sure, but not much.

Banks also probably would have been able to engage profitably in insurance agency, or the selling, but not underwriting, of insurance. Unlike securities underwriting, insurance agency could have benefitted a wide range of banks, large and small. But still, the impact on profits probably would have been modest. Take, for example, Marsh & McLennan, one of the nation's leading brokers. During the 1980s, it earned a total of \$1.7 billion.³³ If Citicorp had been able to earn half of this amount, and then retained half of that, its capital would be approximately \$400 million larger than it is now. Together with the foregoing illustrative gains from securities underwriting, the total gain to Citicorp's capital from the two activities combined still would have been only about \$600 million, a more substantial sum, but again one that could easily be swallowed up by future additional writeoffs for bad loans.³⁴

Accordingly, those who have urged that banks be given broader activity freedom have placed greater emphasis on the benefits of diversification rather than the enhanced profitability alone. Yet, on this subject the evidence is far more inconclusive than with respect to interstate banking. In brief, while there are numerous studies finding that bank (or holding company) profits would be higher and/or less risky if banks were permitted to affiliate with a wide range of non-banking activities, these studies reach conflicting conclusions on which activities would be most risk-reducing.³⁵ In addition, some studies find no significant effects on risk reduction. To compound matters, the studies yield

32. Calculated from data provided by Value Line.

33. *Id.*

34. At year end 1991, Citicorp's non-performing assets totalled \$13.7 billion, or more than 20 times the estimated gain of \$600 million. See *Top 25 Bank Holding Companies*, AM. BANKER, Feb. 3, 1992, at 7. It is conceivable, of course, that had Citicorp been permitted to sell insurance in the 1980s it might not have engaged in risky lending to the degree that it did.

35. A useful review of the literature is provided in Elijah Brewer III, Diana Fortier & Christine Pavel, *Bank Risk from Nonbank Activities*, FED. RESERVE BANK OF CHICAGO ECON. PERSP., July-Aug. 1988, at 14-26. The most recent study of this genre uses options pricing analysis and finds strong evidence that activity diversification by banks is risk-reducing. See Anthony Santomero & Eik-June Chung, *Evidence in Support of Broader Bank Powers*, FIN. MARKETS, INSTITUTIONS & INVESTMENTS (N.Y.U. Salomon Center, 1992).

different estimates of the benefits of activity diversification over different time periods.

Rather than waiting for economists who study the past to reach agreement about the gains from activity diversification in the future, it may be more productive to look at how market participants who have such freedom are actually behaving. Thus, in Europe, where banks have much broader activity authority than their American counterparts, banks are racing either to acquire or to affiliate with insurers and securities firms. In France, for example, banks now are active sellers of life insurance. Banks are moving aggressively to merge or form alliances with insurers in Germany, the Netherlands, and the U.K.³⁶ Clearly, if the market is producing any useful information (an assumption which assuredly some may contest), it is telling us that institutions with financial (rather than intellectual) capital at risk believe there are profits to be made from joining banks with non-bank operations.

I conclude from the mixture of academic and market-based evidence that broader activity authority conceivably could have made some banks safer during the 1980s and conceivably could have moved the profit distribution (shown earlier in Figure 1) to the right, but I question how much or how significant the effect would have been. My skepticism is amplified by two additional factors.

One, which I have already mentioned, is that a good part of any additional profits would have been competed away and provided instead to consumers. The other factor, potentially of much more importance, is that as the thrift experience taught us, activity diversification can backfire if not accompanied with appropriate safeguards.

Specifically, one of the lessons of the thrift crises of the 1980s is that it is foolish to give new powers to nearly or already insolvent institutions with little or no experience in the new activities and with ample incentives to take risks at the deposit insurer's expense. Thus, while I do not fault the liberalization of lending authority for thrifts in the early 1980s per se, I do fault policymakers for not accompanying that deregulation with intensified supervision and with aggressive regulatory measures to restrain the growth of weak and failed thrifts (assuming no additional money would have been appropriated to shut them down).

Applied to the banking context, this experience suggests that it could have been quite dangerous to have given weak banks broader activity authority in the 1980s, especially if that permission had been granted directly rather than

36. Thus, for example, West Germany's Allianz has agreed to joint market insurance and banking services with Dresdner Bank. In Great Britain, Lloyds Bank PLC has acquired a majority interest in Abbey Life Group. And in the Netherlands, NMB Postbank has merged with Nationale Nederlanden. For a sample of articles describing the banking/insurance combinations, see John Evans, *Bank Mergers With Insurers Grow Globally*, AM. BANKER, Apr. 5, 1990; Richard Lapper, *Europe's Banks Discover the Meaning of Life*, FIN. TIMES, Feb. 7, 1991.

to their holding companies. For then, banks with incentives to gamble, like their thrift counterparts, could have been given new and perhaps riskier ways to lose money. To be sure, the lending areas where they did make mistakes—notably commercial real estate and HLT lending—represented substantial risks themselves, most likely greater than securities underwriting and certainly greater than insurance or real estate agency. But consider for a moment if weak banks had been permitted to engage in an unrestricted fashion in real estate equity investment, or much less attractively, in property-casualty insurance underwriting. It would not be surprising that a number of large, currently troubled institutions could have used these particular powers to have plunged even more deeply into the red.

In short, the counterfactual effects of activity deregulation cannot be considered in a vacuum. Although broader powers would have improved the profitability of larger banks, the risks inherent in certain non-banking activities could have been even more dangerous for those banks that sought out more risk during the last decade.

IV. Alternative Causes of Bank Difficulties

In sum, broader geographic and product-line authority for banks during the 1980s would have improved overall bank performance, modestly lowering the number of failures and improving the presently precarious condition of some of our larger banks. If nationwide banking, in particular, had been authorized many decades before, it is likely that substantially fewer bank failures would have plagued the nation during the past decade.

These conclusions are of more than academic interest. Although Congress failed to authorize either nationwide banking or broader product-line freedom for banks in 1991, these issues will remain at the forefront of the political and regulatory agenda. Nevertheless, precisely because broader powers—both geographic and product—probably would not have prevented many of the bank failures of the 1980s, it is useful to consider briefly what other policies, if any, might have done a better job.

Most important, regulators should have constrained the growth of weakly capitalized banks, as well as thrifts, that have the greatest incentives to take advantage of the “heads I win-tails you lose” feature of federal deposit insurance. To make such a policy effective, regulators would have had to use more realistic, market-based measures of the net worth of the depositories they supervised, rather than the artificial equity figures based on historical costs. Indeed, there is little question that regulators exercised forbearance for many of the nation’s largest banks following the LDC debt crisis in the early 1980s, by not requiring these institutions to market their LDC debt, by not curtailing their dividends, or limiting their growth. As a result, many of these institutions

were allowed to grow throughout the rest of the decade, devoting additional deposit funds to riskier and riskier projects. Had the growth of many of these larger institutions been curtailed, or had they been required to raise additional capital, it is doubtful that they would be experiencing the problems which they now face. Equally significant, fewer dubious projects would have been financed, reducing the current oversupply of commercial real estate and thus mitigating what has been one of the nation's severest commercial real estate depressions since World War II. Growth limits and sounder capital regulation, however, would not have prevented the troubles experienced by many banks during the 1980s that failed to diversify their lending. Such large failures as the Bank of New England, as well as the difficulties experienced by so many banks in the Washington, D.C. area, were traceable to rapid expansion of commercial real estate bank loans in particular. Growth limits based on weak capital positions would not have prevented these banks from engaging so heavily in real estate lending since most of these banks reported healthy capital ratios up until the markets turned sour. Instead, regulators would have been wise to have imposed loan diversification requirements that would have inhibited banks from betting so heavily on commercial real estate projects.³⁷

Finally, more intensive supervision, which admittedly would have added to regulatory costs, would still have been cost-effective given the sizeable costs of bank failures that ensued. It is no accident that so many banks failed in Texas during a period when failed banks in that state and elsewhere throughout the Southwest were examined less frequently than any other failed banks in the nation in the 1980s.³⁸ In this regard, it is disturbing that as the decade wore on, it took longer and longer for regulators actually to close banks they had designated as problem institutions.³⁹ Had this forbearance not been practiced, it is likely the banks that were resolved would not have deteriorated so dramatically. In addition, while a lower deposit insurance ceiling (below the current limit of \$100,000 per account) would not have materially dampened the deposit-gathering abilities of the large "too big to fail" (TBTF) banks, it probably would have restrained the growth of smaller banks not protected by TBTF. This, in turn, would have moderated resolution costs.

37. Indeed, in the fall of 1991, the General Accounting Office released a study criticizing supervisory failures on the part of the Comptroller of the Currency in the Bank of New England matter, an assessment with which a spokesperson for the Comptroller essentially agreed. See Susan Schmidt, *GAO: Supervision Lax Over New England Bank*, WASH. POST, Sept. 17, 1991, at D1-2.

38. See John O'Keefe, *The Texas Banking Crisis: Causes and Consequences 1980-89*, 3 FDIC BANKING REV. 1 (Winter 1990).

39. Thus, in our *BANKING INDUSTRY IN TURMOIL* study, we found that in 1980, 15 months elapsed on average between the designation of a bank as "problem" and its later failure. By the end of the decade, it took regulators 28 months before problem banks that failed were actually resolved. *BANKING INDUSTRY IN TURMOIL*, *supra* note 5, at 81-82.

Conclusion

There is little doubt that the U.S. financial services industry—and its banking component in particular—continues to be in need of structural reform. However, it is important to be realistic about what such reform can be expected to accomplish. Broader interstate authority, coupled with broader product-line freedom with suitable safeguards, clearly would reduce the risks associated with banking. It is less likely, however, that it would enhance the industry's average profitability, since most of any cost savings would be passed on in the form of lower prices of financial services for consumers. Also it is doubtful that either broader geographic or product-line freedom would significantly reduce the numbers of bank failures during the next several years. Over the longer run, however, both reforms would strengthen the banking system and serve the interests of consumers better than the current regime.