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The New Interstate Banking and Branching Law of 1994 . . .

Impacts on the Banking Industry and Information Services

Overview

Bank merger and acquisition planning, discussed in INPUT's 1994 *Banking and Finance* industry report, must consider the impact of the Clinton Administration's recently enacted (September 29, 1994) Interstate Banking and Branching Law. This Research Bulletin expands on the report's analysis, Outlook for Regulatory Reform, and discusses the impact of the new legislation, which allows banks to operate multi-state branching systems.

Banks: A Definition

The general definition of a bank is that it is a financial institution that both accepts deposits and makes loans. It is this type of institution that is the primary focus of the new interstate branching legislation.

In addition to operating traditional banks, the larger bank holding companies often form special-purpose subsidiaries (SPSs) to handle a single type of financial service (e.g., mortgage banking, leasing, industrial finance, credit card processing). SPSs are often located in areas where operating costs are especially attractive. For example, in moving its credit card operations to South Dakota, Citibank was able to acquire space and staff at much lower rates than it was paying in the New York area. State and local economic development authorities have frequently encouraged such moves, especially in areas of chronic underemployment. Some of their incentives have included subsidized financing for facilities (e.g., through industrial revenue bonds), training grants for staff, and favorable tax treatment.

While some SPS units are formally chartered as banks, others use a different legal structure. Although SPSs are integrated into the industry's regulatory and processing infrastructure, they differ in one important respect from traditional banks: They are generally only on one side of the loan/deposit equation. For example, though a credit card bank makes loans (through the card), it does not accept deposits; its loans are funded through other means (e.g.,

capital contributions from the holding company, securitization of card portfolios, etc.).

Pre-Legislation Environment

Before enactment of the recent legislation, the regulatory situation facing banks and holding companies was generally as follows:

- Prior to 1985, banks and bank holding companies were generally not allowed to start or acquire banks outside their home state. However, there was no prohibition against a bank acquiring the operations of a competitor in the same state as long as the transaction did not create undue monopoly concentration. Although certain existing multi-state operations (e.g., First Interstate Bank) were grandfathered in, each of the individual state banks had to be a separately capitalized, standalone entity.

- Nevertheless, the FDIC and other federal regulatory authorities did permit several large and profitable banks and S&Ls to acquire failing institutions in other states if there was no local institution able to absorb them. For example, in 1982, Citibank acquired a large failing California institution (Fidelity S&L, headquartered in Oakland) when no local bank was willing to take it off the regulators' hands.

- Following a Supreme Court ruling in 1985, federal regulators began to allow bank holding companies to establish and/or acquire separate banks in multiple states under certain defined conditions. This ownership was also subject to state restrictions, which typically included reciprocity between the holding company's state and the state in which the new bank was established or acquired.

- Following this ruling, some states and regions enacted protective legislation to discourage large out-of-state banks from entering their markets through acquisition. At the same time, this legislation was also intended to encourage the development of large regional banks. The growth of NationsBank, now one of the largest in the country, is the result of the Southern Compact, one such pact among a group of Southern states.

- Even where a holding company does own institutions in multiple states, and uses a common naming pattern for all banks, each institution still has to stand on its own from a financial and regulatory standpoint. That is, each institution must still:

  - Be separately capitalized

  - Maintain its own separate books

  - Be separately subject to examination and regulation

- Branching regulations for each individual bank currently remain the province of the individual states. For example, Illinois is a unit banking state; no Illinois bank may have more than one branch. By contrast, California allows unlimited statewide branching, and Bank of America has over 1,000 branches statewide.

- In general, SPSs are not subject to these constraints because they are not banks in the traditional sense (i.e., both deposit accepters and lenders).

The New Legislation

The basic thrust of the new legislation is to eliminate the customer service barriers that exist between multiple banks that are separately incorporated in different states. This would allow institutions such as Bank of America, NationsBank, First Interstate and Citibank to combine their multiple bank charters into one, and operate a single bank with branches in multiple states. Each of

these branches would then be able to offer the full range of deposit and loan services to its customers, no matter where the customer resided, the account was located, or the transaction initiated. Major provisions of the new legislation are as follows:

- One year from the signing of the bill, in September 1995, bank holding companies will be able to acquire or establish subsidiary banks in any state. As today, these will still have to be separately chartered, standalone institutions. This provision essentially ratifies the situation that arose from the 1985 Supreme Court decision, except that reciprocal state pacts are no longer necessary for these acquisitions to occur. Because 14 states still have not made such pacts, this will open up a number of markets, including Wisconsin, Iowa, Kansas, Montana, Missouri and Hawaii.

- Starting June 1, 1997, banks will be able to merge across state lines, provided that states do not meanwhile adopt legislation prohibiting these combinations. Special-purpose subsidiaries can also be converted into banks and merged into the new multi-state branch systems at that time. The resulting institutions would be headquartered in a single state, but able to operate branches in any other state. States can also adopt legislation to permit multi-state branching before June 1, 1997.

- In order to control concentration in both local and national markets, mergers and acquisitions would be limited in cases where the combined bank would control more than 10% of insured bank deposits nationwide, or 30% of the deposits in any single state. However, individual states could waive their 30% limit if they chose.

Key points are summarized in Exhibit 1.

Exhibit 1

Summary of Key Provisions

- 1995 - Bank holding companies can acquire or establish subsidiary banks in any state
- 1997 - Banks will be able to merge across state lines, with some restrictions
- Some limitations apply, based upon share of deposits

Source: INPUT

Proponents of the new legislation cite several key advantages to multi-state branching:

- *Improved customer service* - By expanding their geographic reach and operating through a single unified branch system, large banks can simplify and reduce the cost of the checking, funds transfer and lending services they offer corporate customers. Similar advantages will also accrue to retail customers (see *ATM Usage and Retail Banking Transactions*).

- *Reduced portfolio risk* - Expanded branch networks should also allow banks to diversify their lending, both geographically and across industries, therefore reducing their risk exposure to special problems that may affect a given industry or region.

- *Reduced operating and regulatory costs* - By operating one bank instead of many, the costs of institutional overhead (staff, facilities, etc.) and regulatory reporting can be significantly reduced. The head of one of the largest banks has estimated that it can save over $50 million per year through such overhead cost reduction.

Impact on Bank Merger Activity

What is the likely impact of this new legislation on bank merger activity? In INPUT's view, not much.

The basic rationale for bank mergers is to acquire additional customers while reducing the costs of the combined operation. In looking at potential merger partners, a bank has three options:

- *In-market* mergers, where two institutions are in the same state. Recent in-market transactions have included Chemical/Manufacturers Hanover, and Bank of America/Security Pacific.
- *Regional* mergers, where institutions are in neighboring states. These mergers are often done in the context of a regional pact, such as the Southern Compact, which ultimately led to the formation of NationsBank.
- *Out-of-market* mergers, where two institutions are in different states. One recent example is the Bank of America/Continental Bank transaction.

In the first two situations, there are economies of scale in consolidating some activities. For example, SPSs are typically holding company subsidiaries, and duplicate mortgage companies, leasing companies, credit card processing facilities, etc., can be combined for cost savings. Corporate advertising/identity programs can also be consolidated, giving a better return for advertising expenditures as regional identity and marketing programs are developed. Some operations can also be consolidated through the use of processing services contracts or subsidiaries run by the parent holding company.

With in-market mergers, there are additional savings available from closing overlapping branches and ATM facilities, merging duplicate operations such as credit and lending, corporate processing services and retail services, eliminating duplicate corporate staffs and regulatory reporting, etc.

However, all of these opportunities are available today under the current regulatory environment. Interstate banking brings essentially no new advantages to the in-market merger. And the primary advantage to regional market mergers is the reduction in overhead cost identified earlier. Without other compelling reasons for a merger, these potential cost savings are not large enough to motivate additional new mergers; nor would the lack of these potential savings stop mergers that were otherwise justified on strategic or competitive grounds.

Holding companies that already have multi-state operations will obviously move to combine their separate banks into one, for the reasons cited above. Customers of First Interstate Bank, Citibank, Bank of America, NationsBank and others will see improved service, and the banks themselves will profit. But these are new mergers in name only; the original acquisitions took place years ago.

Out-of-market mergers have historically been fewer in number, because there were fewer advantages to be found. The BofA/Continental merger is a unique situation based on the unusual synergy between the two institutions. Continental is a corporate bank in a unit-banking state, with a client base that has little overlap with BofA. Continental had a reputation for smooth operations that could easily be continued under the acquisition. By acquiring Continental, BofA gained a large new base of corporate customers whose loan requirements had never been funded by a large deposit base. The lack of a branch network was actually an advantage for BofA, as it made the acquisition easier to assimilate.

In this case, the major advantage of a multi-state branching law would have been to simplify the bank's business relationships with large, multi-state customers. Again, this is a minor item, not a strategic issue that would decide the fate of a potential merger.

Impact on Information Services

Although the outcome of the pending legislation was not clear when INPUT originally developed its 1994 market projections, passage of the law (in much this form) was anticipated and considered in the preparation of the industry forecast. Accordingly, the final result is not significantly different from the scenario presented in the 1994 Banking and Finance industry report.

The increase in merger activity will likely be most pronounced in the states that currently do not have any reciprocal banking compacts.

The approach to consolidating operations in merger situations will not change as a result of this legislation. As today, systems will be evaluated for their commonality of function, and operations will be converted to common systems on an individual basis as dictated by potential cost savings.

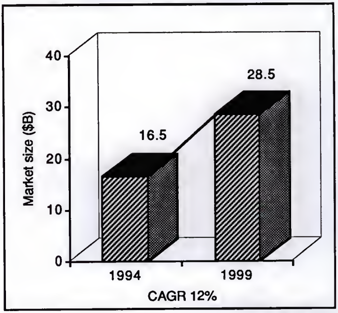
Most large legacy systems have the capacity to absorb significantly increased transaction volumes without substantial change, and continuing advances in mainframe power and price/performance guarantee a continued life to many such systems. Reengineering of legacy systems will continue, using client/server front ends and assorted back-end database servers to improve performance and user friendliness. The market for both software and professional services will continue to be strong in these areas.

Professional services and systems integration (SI) activities will also be required to support database and processing conversions associated with mergers or acquisitions. Balancing the potential loss of site licenses (as a result of operations consolidations) is the potential growth in software product sales as banks expand customer services and banking product offerings in the new, more competitive, financial arena.

One effect of the growing importance of systems integrators to banking is reflected in INPUT's 1994-1999 market forecast. Applications software products, the largest category of information services spending in this industry, will grow at 9% over the five-year forecast period, while software products delivered through systems integrators will increase at 22%. The growth difference does not reflect the total market size, however, and the SI-based market is growing from a comparatively small base. INPUT's estimate of overall information services spending in this marketplace for 1994 and 1999 is shown in Exhibit 2.

Exhibit 2

Banking and Finance, Information Services Market, 1994-1999



Source: INPUT

Finally, INPUT's outlook on the future of the industry remains basically unchanged. Because this new legislation does not generate any compelling new savings for banks, nor any compelling new incentives to merge, we continue to see an industry that will be highly fragmented, with many thousands of small local institutions competing successfully with a few regional and nationwide giants.

A good analogy may be the retail consumer market of 20 years ago. At that time, large department stores coexisted with small specialty stores, and both were profitable. The big change in the retail market has been the evolution of the discount/ warehouse type of operation. No such structural change appears likely in the banking market.

While recent moves such as Microsoft's acquisition of Intuit have raised the stakes in the home banking market, this is still an over-analyzed, underdeveloped situation that does not pose a serious threat to the banking business itself. In the 20+ years since they were first deployed, ATMs have only slowed the growth of branch banking, not stopped it. And ATMs have had no apparent impact on the number of institutions or other industry demographics. For example, small local banks—even unit banks, in Illinois—can all issue ATM and credit cards to their customers. Indeed, by providing the facility for simple, low-cost access through home computers, Microsoft may actually help the small local institution to survive and compete more effectively against the corporate giants.

This Research Bulletin is issued as part of INPUT's Information Services Market Analysis Program—U.S. If you have questions or comments on this bulletin, please call your local INPUT organization or Robert L. Goodwin at INPUT, 1881 Landings Drive, Mountain View, CA 94043-0848, (415) 961-3300.