Bruce

CB Banks

MEMORANDUM

THE WHITE HOUSE

WASHINGTON

June 20, 1993

MEMORANDUM FOR SHIRLEY SAGAWA

FROM: **Paul Weinstein**

SUBJECT: **Community Development Banks and National Service**

Per our discussion last Friday, this memo outlines how we might match the President's Community Development Financial Institutions (CDFI) and National Service legislation.

Under this proposal, an undergraduate business major could meet his/her community service requirement under the National Service proposal by serving a two-year apprenticeship at an accredited CDFI -- Community Development Banks (CDB), Community Development Credit Unions (CDCU), Micro Loan Funds (MLF), Revolving Loan Funds (RLF), and Community Development Corporations (CDC). The service could be as an accountant, junior loan officer, teller, customer and technical service staffer, assistant investment banker, junior commercial developer officer, etc. The student would gain hands-on financial skills while the CDFIs would have access to a much larger pool of personnel trained in finance and accounting. As long as we stipulated that the community service commitment could only be met by two years of work at a CDFI accredited by our national network, monitoring the service requirement would be relatively easy.

Under this scenario, some students might even continue to work at CDFIs, or even start one. Even better however, would be for these individuals to take positions at traditional banks and other financial institutions. If loan officers trained at CDFIs took jobs at mainstream banks, we could see an unprecedented amount of lending activity in lower- to moderate-income communities. With the knowledge, unique expertise, and energy of these individuals, banks would meet their Community Reinvestment Act requirements in a meaningful manner.

During the campaign, President Clinton spoke at the Wharton School of Business, and criticized business students for creating an investment banking club called the "Unindicted" and for "pursuing high incomes in high finance rather than in the apparently less glamorous work of creating jobs, goods and services to make America richer." In four years, the President could return to Wharton, and talk about how a whole new breed of business student, trained at CDFIs through the National Service program, was changing the way traditional banks lend and reinvigorating the community spirit at financial institutions.

cc: Bruce Reed
Gene Sperling

Dave FYI -pgw Thanks -BR

DRAFT

DRAFT -- OPTIONS FOR CD BANK FUND

May 24, 1993

1) Create a private Fund and a Federal regulator as follows:

- the private Fund would have a Board of the five agency heads (HUD, Ag, Treasury, Commerce, and SBA) and 7-10 private citizens, initially appointed by the President. After one year, private shareholders would elect the 7-10 private Board members;

  (note: election would occur no matter how little private funds have been invested, but some private funds are required.)

- give the appropriation funds to the private entity as a grant perhaps with some requirement (or at least a goal) to generate matching private funds;

- use the existing HUD regulator (the Office of Federal Housing Enterprise Oversight -- Fannie and Freddie's regulator) in consultation with Ag, or alternatively, create a new regulator. The regulator would have programmatic oversight responsibilities including ensuring that the Fund carries out its public purpose under the statute;

- regulator would interact with the entity to enforce virtually all conditions currently provided for in the draft bill. The regulator would have authority to require the Fund to seek prior approval for all its activities;

- only the appropriation amount (and any costs of the regulator) would be included in the budget, once private shareholders elect a majority of Board members as described above.

2) Revise existing Fund proposal as follows:

- allow the five agency heads to choose six private Board members until successors are elected;

- The $382 million would be used either to purchase nonvoting stock in the Fund or as a direct grant to the Fund;

- the six successors would be elected in an election held by September 30, 1994. Shareholders would vote in proportion to their voting shares;

(note: election would occur no matter how little private funds have been invested, although some private investment would be required.)

- include Fund on the budget until six Board members are elected by the shareholders (for the fiscal year 1995 budget at the latest).

Note: we are also trying to find a way to ensure community groups representation on the Board under either scenario. One option would be to sell different classes of voting stock, some restricted to community groups only. Another might be to have the Board elect several community group representatives. We are still considering how best to address this.

Recd.

THE WHITE HOUSE

WASHINGTON

May 25, 1993

Paul D. —
Any model will do,
so long as the Pres.
puts Elk Horn · South Shore
on the board.
BR

MEMORANDUM FOR CHRIS EDLEY

FROM: PAUL DIMOND

SUBJECT: STRUCTURE FOR CDFI FUND

There appear to be at least five models for the structure of the CDFI Fund:

- the private fund with Presidential appointment of all Board members as proposed in the current draft of the bill

- Bob Nash's proposed modification of the current draft, whereby successor Board members are selected by existing Board members (as in most Directorship non-profit corporations, although a "membership" form of non-profit corporations might also be envisioned)

- a private fund with election of a majority of the Board members by shareholders no later than 1995

- a private fund with a majority of Board members elected by shareholders after first year but with a Federal regulator to assure fulfillment of public mission

- one fund to receive and to expend the federal appropriations in the current draft bill plus an affiliated private fund (or funds) to receive private investments, program related investments and charitable contributions

Under any structure, the legislation could affirmatively state (a)that there is no implicit federal guarantee of investment to or by the fund(s) and (b)that private investments and private contributions are receipts of the fund(s) and not of the government and that any investments or grants made from such non-federal sources are expenditures or investments of the fund and not of the federal government. Under any structure, we do not want under the federal budget to have private investments or contributions to the fund(s) scored as revenues to the government or investments or grants by the fund(s) from such non-federal sources scored as outlays by the government.

I would appreciate OMB's analysis of how each of the five alternatives would be scored and whether there would be any implicit guarantee under such circumstances.

In order to inform OMB's analysis and our choices, please analyze the following governmentally created private entities to determine (a) how each is scored for budget purposes, (b) what is the source of funds, (c) is government implicitly liable for any private investments, and (d) what is the governing structure of the entity:

- Consolidated Rail Corporation
- College Construction Insurance Loan Association
- Corporation for Public Broadcasting
- AMTRAK
- Neighborhood Reinvestment Corporation
- Polish-American Enterprise Fund

Please also advise if there other similar, governmentally created private funds and provide the same analysis.

Thank you for your continuing assistance. This is obviously a matter of high priority. We hope to gather the principals of the Working Group together on Tuesday June 1 to review OMB's analysis and recommendation and to make a final decision so that we can complete drafting of the CDFI bill.

PROJECT 76 - AN AMERICAN AFFAIR, INCORPORATED

"PHILANTHROPY FOR THE 1990'S AND BEYOND"

2400 SIXTEENTH STREET, NORTHWEST
SUITE NUMBER 545
WASHINGTON, DISTRICT OF COLUMBIA 20009
TELEPHONE (202) 483-0684
FAX (202) 483-0940

Mr. L. Napoleon Cooper
Volunteer Chairman and
Chief Executive Officer

Perry M. Hoisington
Major General USAF, Retired
Volunteer Advisory Vice Chairman

April 27, 1993

ORIGINAL COPY FOR MR. BRUCE REED (DOMESTIC POLICY COUNCIL)
The Honorable Frank N. Newman
Undersecretary of the Treasury for Finance
United States Department of the Treasury
1500 Pennsylvania Avenue, N.W. Room 3312
Washington, D.C. 20220

Re: *Supplemental Private Financing for Bridging the Gap Between Available Public Funds and President Clinton's Community Development Bank and Other Credit Expansion Goals*

Dear Undersecretary Newman:

I am writing at the suggestion of Mr. Paul Diamond, Assistant for Community Development at the *National Economic Council*, in order to introduce you to our unique *community development bank* (or "CDB") and credit expansion proposals that call for Congress and the Administration to support the enactment of legislation that would allow the creation and *private* capitalization of a new super class of *"safe" national development banks* (or "SNDBs").

I am also writing in order request a meeting with you because we understand that you are either personally interest in or have jurisdiction in your Treasury department position over CDB, public debt management, credit expansion and "nation-wide" branch banking issues.

While, such a meeting would afford us many important opportunities, including:

- to follow-up my conversation with *Deputy Secretary* Roger C. Altman, on the subject of our unique new non-profit sector financing strategy called the **Charitable Bond;™**

- to show how an action the Treasury has previously expressed a strong interest in taking could have a measurable near-term stimulus impact upon our economy and, have great significance for the *full* funding of Administration goals in this area and,

- to answer any questions you and your office may have concerning either our new SNDB or our Charitable Bond™ proposals,

our main goal will be to demonstrate as conclusively as possible why we think it would be *unnecessary* to see the potential of President Clinton's "100 new community development banks" initiative, diminished by an understandable inability of government to reconcile the limits of *public* funding with the urgent need to redress the wide-scale economic distress that every American hopes can be mitigated by new credit expansion proposals.

Specifically, we believe that Congress and the Administration should support *combining* the good features of *all* CDB approaches that could have a measurable impact upon this national problem, with the substantial *private* financing that *only* our SNDB and Charitable Bond™ proposals can generate, including for CDB ideas being developed in the public sector and by existing or proposed *community development financial institutions* ("CDFIs").

We are confident that once you become more knowledgeable about our proposals, you will agree with us that by marshalling the measurable funding that the Charitable Bond™ can generate and by utilizing the experience of existing CDFIs and *Community Reinvestment Act* (or "CRA") regulated for-profit institutions, market forces can be expected to help the President's much anticipated 100 new community development banks initiative to facilitate:

- an up to 80 basis points reduction in overall borrowing cost for the U.S. Treasury;
- the creation of new competition that expands credit availability in depressed areas;
- the ability of new CDBs to build upon the experience of CDFI and CRA regulated institutions in order to utilize the significant annual capital investments of SNDBs;
- the introduction of new capital formation strategies that will enable non-profits to match *public* funds a CDB receives under the President's proposal (expanding *private* social welfare investment in areas where CRA, CDFI and SNDB lending occurs);
- the *substantive* empowerment of citizens in depressed crime-ridden urban areas, and
- the financing of public-private joint-ventures and matching-funding for community development banker apprenticeship, job training and national service initiatives.

Again, while I recently received a letter from the *Acting* Assistant Treasury Secretary for Domestic Finance which indicates that she is aware of my conversation with the Deputy Secretary about the Charitable Bond™ itself, we wish to meet with you because of your interest in these issues and because your Treasury office intersects with our broader initiative at more points than any other position in the federal government.

In conclusion, I want to reemphasize our opinion that in order to achieve the goals of the President's much anticipated CDB proposal, advantage must be taken of the best features of all related initiatives. We look forward to discussing the matter with you in more detail and thank you for your consideration.

Sincerely yours,

I. [signature]

Enclosure:

cc: Messrs. Paul Diamond, David Lebryk, **Bruce Reed**, Gene Sperling and, Paul Weinstein, The Honorable Henry B. Gonzalez and Donald W. Riegle, Jr. and, Ms. Deborah J. Danker

PROJECT 76 - AN AMERICAN AFFAIR, INCORPORATED
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Mr. L. Napoleon Cooper
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Perry M. Hoisington
Major General USAF, Retired
Volunteer Advisory Vice Chairman

April 13, 1993

The Honorable Donald W. Riegle, Jr.
Chairman
Senate Committee in Banking,
Housing, and Urban Affairs
105 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Riegle:

I am writing to you in order to inform the Committee on Banking, Housing, and Urban Affairs of the long-standing desire of *Project 76 - An American Affair, Inc.*, to participate in hearings and other forums intended to present *new credit formation* and *depressed community development* policy options to the United States Senate for consideration.

We are particularly interested in *community development bank* ("CDB") options and in any consideration the Senate may be giving to reducing insurance premiums or the supervision and regulation of financial institutions, with the objective of either enhancing *Community Reinvestment Act* ("CRA") compliance or of facilitating new credit formation.

Our interest in these issues is derived from the fact that we have developed a unique "market" driven option that would help government to expand community development and to ease the "credit crunch" for small-to-medium sized commercial and industrial concerns.

Further, unlike any other approach that we are aware of, ours would enlist *private* capital to achieve immediate <u>measurable</u> results in these important areas, without undermining the safety or soundness of new or existing financial institutions and it would *not* entail expanding off-budget government liabilities, creating new tax-payer financed subsidies nor would it reward institutions that can <u>not</u> show that they make an effort to comply with the CRA.

SUMMARY

Simply stated, our proposed solution for redressing the lack of credit and other banking services in certain areas of our economy is good *old-fashioned American competition.*

That is, competition in the form of new "safe" national development banks (or "SNDBs") which the Senate can help facilitate the formation and private capitalization of, by enacting legislative *exemptions* for SNDBs from banking laws that limit who may own equity stakes of greater than 25 percent in bank holding companies and, that exempt them from laws and Federal Reserve System regulations that would prohibit "nation-wide" bank branching.

Based upon an analysis of the community development and credit-crunch issues, we believe that in order to achieve Congress and the Administration's stated goal of seeing an immediate measurable increase take place in the availability of credit for small-to-medium sized commercial and industrial companies in depressed communities and/or to see created an environment where market forces would drive existing federally insured institutions to make the loans in question, the Committee needs to seriously consider recommending that the United States Senate enact timely SNDB enabling legislation.

THE SPECIFIC SNDB COMPETITION PROPOSED

Accordingly, under the new business conditions that would exist under our proposal, regulated financial institutions with problematic track-records in certain areas, including:

- unsatisfactory Community Reinvestment Act ratings;
- racially discriminatory mortgage and consumer lending and/or employment practices;
- questionable third-party mortgage lending relationships and/or
- direct lending patterns viewed as "red-lining" by local communities,

would face stiff SNDB public relations and banking services competition, that could manifest itself on a number of fronts, including competition for:

- public sector, retail and socially conscious investor deposits;
- *Federal securities purchases;*
- consumer loans;
- secured credit cards;
- retirement account services;
- small business and mortgage loans, and for
- low-cost capital in the debt and equity markets.

On the other hand, financial institutions generally would be afforded every opportunity to maintain their competitive positions, via loan participations and non-profit sector financed support social services wherever CRA lending takes place. Also, they would have an equal opportunity to create SNDB units of their own or to invest in the equity of others.

SAFE NATIONAL DEVELOPMENT BANKS

While Congress can facilitate the formation and capitalization of SNDBs and permit the implementation of our proposed SNDB *market* solution by enacting legislation that would:

- *insist* on a minimum $1 billion initial capitalization for new SNDBs;

- *require* SNDBs to lend from their capital rather than from insured SNDB deposits;

- *demand* that SNDBs lend *exclusively* to small businesses and mid-sized commercial and industrial companies and community development initiatives in depressed areas;

- *stipulate* that no less than half of a new SNDBs lending and operations be directed toward African-American and other minorities in the most depressed *urban* areas;

- *direct* that SNDBs make *reasonable* efforts to facilitate new investment in America's social infrastructure, including summer jobs, public education and "national service" and "youth apprenticeship" training programs for SNDB and CDB bankers and,

- *encourage* SNDBs to finance minority, local community, small business and small investor acquisitions of real estate, thrift and other assets from the R.T.C.,

Project 76 would be the driving force behind actually forming and capitalizing the initial SNDB, via a new non-profit sector financing stratagem called the **Charitable Bond.™**

PROJECT 76 - AN AMERICAN AFFAIR, INCORPORATED

Project 76 is a 501(c)(3) and 509(a)(2) tax-exempt entity. It has a capital structure that is uniquely more akin to that of a commercial bank rather than to that of a publicly charitable corporation. It was founded in 1973 and recognized by the I.R.S. in 1977 (letter attached).

Simply stated, *Project 76*, creates a private institutional base for the finance and administration of fundamental public works, services, social welfare and other public interest activities of benefit directly or indirectly to the overall society. Programs undertaken by this charitable corporation are to be done individually and/or in association with and to the specifications of federal, state and local governments.

Preparation for this activity has been in progress for better that 20 years. In fact, establishing the proper plan of operations, which would assure financing the charitable corporation with funds of the enormous magnitude required to accomplish the mission of *Project 76*, made it essential that the organization ground itself thoroughly in such disciplines as: general securities law; non-profit organization and operations law; the tax economics of charitable giving and, the innovative new field of corporate finance for charitable fundraising -- not to mention the expertise its officers had to master in mathematical model design and specialized computer operation in order to prepare the enormous quantities of financial calculations submitted for evaluation by some of the nation's foremost experts in the fields of tax analysis and overall non-profit operations.

The organization has met the formidable challenge of fully designing the operational plan for *Project 76* and is now ready to establish the initiatives that will assure that appropriate private sector efforts are aimed toward both direct and indirect participation in the solution of many of the ever-growing tasks that face federal, state and local governments -- tasks that normally may never be accomplished for lack of funds, low priority position or both.

Throughout its entire 20 year existence, *Project 76* has been the nation's foremost advocate of focusing a more significant portion of private sector commercial, industrial and financial assets towards supplementing the accomplishment of essential programs in the public sector, an approach to the problem that has finally acquired recognition as a sensible and assured way to proceed. Both government and private sector records will reflect the efforts *Project 76* has made in this regard. Certainly, it must at least share in the pioneer status that will someday be recognized in this field.

Project 76, therefore, is proposing that it be permitted to form and capitalize a SNDB through the use of the new Charitable Bond™ product, as new SNDBs would also serve as a focus for the non-profit sector in general and for *Project 76* specifically to channel program spending that is intended to enhance housing, job creation and training, health and child care, as well as public education *wherever* CRA lending takes place.

THE CHARITABLE BOND™

Project 76 informed the previous Administration's White House Policy Office and Treasury Department of the existence of the Charitable Bond™ and demonstrated that it can provide the federal government with "captive" *buy and hold* demand for 30 year maturity Treasury bonds at substantial interest cost savings to U.S. tax-payers. While, we believe that the attention of senior officials in that Administration was diverted from the new bond program by the campaign to re-elect the President, we understand that a "substantive" review of the new bond was conducted, which indicated that *it will not require a change in current Federal income tax laws.* (See copies of related Treasury and White House letters attached.)

The 30 year maturity Charitable Bond™ sales anticipated by our SNDB proposal will offer American investors a fully-assured investment, at an *above-market* rate of return.

Additionally, the Charitable Bond™ sales which will enable *Project 76* to capitalize its portion of the new SNDB's equity capital and to finance other public interest activities in connection therewith, will be *collateralized* by Federal securities purchased by *Project 76* from the U.S. Treasury Department at a very substantial cost savings to taxpayers. *In fact, Charitable Bonds™ will add significantly to the Treasury's revenue base and have a measurable progressively favorable impact upon reducing the federal deficit over the next three decades.*

More technical detail concerning the Charitable Bond™ is available to you and Staff.

DESIRED BANKING LAW AND RESERVE SYSTEM REGULATORY EXEMPTIONS

Finally, as *Project 76* seeks to form an initial SNDB with a capitalization of $1 billion, the new bank and its non-bank owners (including *Project 76* and its financing affiliate) would theoretically be exempt from certain banking laws and regulations including the following:

- *Project 76* and its financing affiliate would be exempt from the Bank Holding Company Act and the Change in Bank Control Act, 12 U.S.C. Section 1841 et seq. and 12 U.S.C. 1817(j), respectively, and from the provisions of the Federal Reserve Board's Regulation Y, 12 C.F.R. Part 225, as well as Section 23A of the Federal Reserve Act and the Reserve Board's Regulation O. Specifically:

1) *Project 76* and its financing affiliate would be exempt from the "activity" limitations of the Bank Holding Company Act - which would otherwise apply based upon the scale of its investment in the new SNDB and its holding company - pursuant to Section 225.31(d)(2)(ii) of Regulation Y and,

2) the SNDB's holding company would be exempt from the Bank Holding Company Act and other laws and regulations, with respect to restrictions that would otherwise limit its ability to acquire banks across state lines and/or with respect to the SNDB and its holding company - which will in all other respects be governed by the Act - *operating an interstate branching network.*

This project is the only private financial program of its kind and scope that will produce funds of such magnitude for the purposes stated. Such a financial opportunity to create additional and much needed funding in these areas should not be missed, especially at this time of our country's need to assure positive business and supportive action on all fronts.

Accordingly, our SNDB proposal can go a long way toward redressing the community development and credit availability shortfalls that confront our economy and it would be prudent for Senators, regulators and industry representatives to become familiar with it.

Project 76, therefore, seeks to be invited to participate in future discussions and hearings on these subjects. May we hear from you?

Thank you for your consideration.

Sincerely yours,

I. Yalon Page

Enclosures:

cc: Steven B. Harris, Esquire
(Staff Director and Chief Counsel)
Matthew D. Roberts, Esquire
(Counsel)

THE WHITE HOUSE

WASHINGTON

June 30, 1992

Dear Sirs:

Thank you for your recent memorandum concerning the Charitable Bond proposal. I understand that Clayton Yeutter's office and the Department of the Treasury have analyzed this proposal and will be providing a substantive response. I appreciate hearing from you.

With kindest personal regards, I remain

Sincerely yours,

W. Henson Moore

W. Henson Moore
Deputy Chief of Staff
to the President

Dr. Louis C. Pendleton
Mr. L. Napoleon Cooper
Maj. Gen. Perry M. Hoisington, USAF Retired
2400 16th Street, N.W., Suite 545
Washington, D.C. 20009

DEPARTMENT OF THE TREASURY
WASHINGTON

MAR 31 1992

Mr. L. Napoleon Cooper
Project 76 - An American Affair, Inc.
2400 Sixteenth Street, N.W.
Washington, D.C. 20009

Dear Mr. Cooper:

Thank you for your letters to Secretary Brady and Mr. Yeutter concerning your Charitable Bond proposal.

We appreciate receiving your information. We too recognize that due to the preferential tax treatment of annuities, many taxpayers are placing their funds in annuities rather than other investment vehicles (e.g., certificates of deposit, or taxable mutual funds), as an investment decision. We appreciate your support for the President's proposal to provide similar tax treatment for investments with similar features.

As we understand your Charitable Bond proposal from the description you provided in your materials, income from the bonds would not receive special tax treatment requiring a change in the current Federal income tax laws. As such, we have taken the liberty of forwarding your materials to Jerome H. Powell, Assistant Secretary of the Treasury for Domestic Finance, whose office administers the issuance of Federal securities, for further review.

Thank you again for writing.

Sincerely,

Glenn Hubbard

R. Glenn Hubbard
Deputy Assistant Secretary
(Tax Analysis)

cc: The Honorable Jerome H. Powell

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Person to Contact: Edward Karcher

Telephone Number: 202-566-3403

Refer Reply to: E:EO:T:R:2-5

Date: JAN 26 1977

Project 76- An American
Affair, Inc.
786 National Press Building
529 15th Street N.W.
Washington, D. C.
20045

Employer Identification Number: 23-7382621
Key District: Cleveland
Accounting Period Ending: February
Form 990 Required: Yes

Dear Applicant:

Based on information supplied, and assuming your operations will be as stated in your application for recognition of exemption, we have determined you are exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code.

We have further determined you are not a private foundation within the meaning of section 509(a) of the Code, because you are an organization described in section 509(a)(2).

You are not liable for social security (FICA) taxes unless you file a waiver of exemption certificate as provided in the Federal Insurance Contributions Act. You are not liable for the taxes imposed under the Federal Unemployment Tax Act (FUTA).

Since you are not a private foundation, you are not subject to the excise taxes under Chapter 42 of the Code. However, you are not automatically exempt from other Federal excise taxes.

Donors may deduct contributions to you as provided in section 170 of the Code. Bequests, legacies, devises, transfers, or gifts to you or for your use are deductible for Federal estate and gift tax purposes if they meet the applicable provisions of sections 2055, 2106, and 2522 of the Code.

If your purposes, character, or method of operation is changed, you must let your key District Director know so he can consider the effect of the change on your exempt status. Also, you must inform him of all changes in your name or address.

Project 76 - An American Affair, Inc.

The block checked at the beginning of this letter shows whether you must file Form 990, Return of Organization Exempt from Income Tax. If the Yes box is checked, you are required to file Form 990 only if your gross receipts each year are normally more than $5,000. If a return is required, it must be filed by the 15th day of the fifth month after the end of your annual accounting period. The law imposes a penalty of $10 a day, up to a maximum of $5,000, for failure to file the return on time.

You are not required to file Federal income tax returns unless you are subject to the tax on unrelated business income under section 511 of the Code. If you are subject to this tax, you must file an income tax return on Form 990-T. In this letter we are not determining whether any of your present or proposed activities are unrelated trade or business as defined in section 513 of the Code.

Please use your employer identification number on all returns you file and in all correspondence with the Internal Revenue Service.

We are informing your key District Director of this action. Because this letter could help resolve any questions about your exempt status and your foundation status, please keep it in your permanent records.

Sincerely yours,

Milton Cerny

Milton Cerny
Chief, Rulings Section 2
Exempt Organizations
Technical Branch

Enclosure

file

PJW —
Good work.
Sarbanes makes me tired.
Hang in there —
BR

THE WHITE HOUSE

WASHINGTON

May 10, 1993

MEMORANDUM FOR BRUCE REED
GENE SPERLING

FROM: Paul Weinstein

SUBJECT: Legislative Strategy On Community Development Financial Institutions Proposal

Background

Last saturday, we had a line-by-line drafting session on the CDFI legislation. All the members of the Inter-Agency Working Group were represented. Treasury is making the changes we agreed to at the meeting, and will be circulating a revised draft later today. I hope to give the bill to OMB on Tuesday, so they can begin their standard legislative referral process. This would allow us to send a bill up to Congress late next week. I also want to send a draft to Matt Roberts of Senate Banking if you both agree.

What Has Been Done

Over the past week and a half, I have gone to the Hill to meet with staff people on the House and Senate Banking Committees. Specifically, I have now met with Reigle's staff four times, and Gonzalez's staff once, last Friday. Today, I went with Chris Edley of OMB and Brian Mathis of Treasury to meet with Senate Banking Committee staffers representing Reigle, Sarbanes, Carol Mosely Braun, and Boxer. I have also met with staff of Representative Kennedy's Banking Subcommittee, which may have some jurisdiction of the legislation.

Tomorrow I am meeting with Kanjorski's and Neal's staffs, because their subcommittees may also have some jurisdiction. The following is a list of Hill meetings:

Meetings with the staffs of:

Sen. Reigle (4 times)
Sen. Sarbanes (1 time)
Sen. Mosely Braun (1 time)
Sen. Boxer (1 time)
Rep. Gonzalez (1 time)

Rep. Kennedy (1 time)
Rep. Neal (tomorrow)
Rep. Kanjorski (tomorrow)

Extensive phone conversations with the staffs of:
Sen. Bradley
Sen. Dodd
Rep. Kanjorski
Rep. Neal

NOTE Sarbanes' staff was somewhat leery of the CDFI concept. We will need to use Bruce Katz to help lobby the Senator.

What Needs To Be Done

The politics of the Banking Committee tend to be parochial rather than partisan. That is why we need to at least approach the Republicans on the committees. In particular, we should meet with Representatives Leach, Roukema, and Ridge, and Senators D'Amato and Bond. Steve Harris, staff director of the Senate Banking Committee, is setting up a meeting with Republican Committee staff. We need a meeting with the House Republican staff as well.

It is also essential that we get minority Members on board. Representatives Flake, Mfume, and Waters are key, as is Senator Mosely Braun. The following is a list of Members that we need to set up a meeting with:

Senate

Banking Committee
Reigle -- Chairman (D-MI)
Sarbanes -- Chairman
Housing Subcommittee (D-MD)
Dodd (D-CT)
Boxer (D-CA)
Mosely Braun (D-IL)

Others
Bradley (D-NJ)

D'Amato -- Ranking Minority Member (R-NY)
Bond -- Ranking Minority Member Housing Subcommittee (R-MO)

House

Banking Committee
Gonzalez -- Chairman House Banking (D-TX)
Neal -- Chairman Financial Institutions Subcommitee (D-NC)
Kanjorski -- Chairman Credit Subcommittee (D-PA)

Kennedy -- Chairman Consumer Subcommittee (D-MA)
Schumer (D-NY)
Frank (D-MA)
Flake (D-NY)
Mfume (D-MD)
Waters (D-CA)

Leach -- Ranking Minority Member (R-IA)
Roukema -- Ranking Minority Member Housing Subcommittee (R-NJ)
Ridge (R-PA)

Other Outreach Efforts

I am planning to give a draft of the legislation to South Shore and Elk Horn to make sure they are comfortable with our approach. Also, I am sending a copy to Konrad Alt at OCC, to make sure the regulators are at least familiar with the legislation. Finally, we will need to get back in contact with some of the community groups. Paul, Sheryll, and I met with Acorn and others a couple of months back. HUD has graciously agreed to meet with these groups so we won't have to again. However, a call to ACORN and a few select others prior to our sending the bill to Congress couldn't hurt.

Appropriations Process

Last, but most important, we need to get a handle on the appropriations process. The committees are starting to take action. We must talk with Mike Wessel in the House and whoever his counterpart is in the Senate, about reserving the $60 million for FY94, contingent on an authorization. I have a call into Dan Kantu of the HUD/VA Subcommittee, because word is they are getting pressured to spend the $60 million on other initiatives. **WE MUST DEAL WITH THIS MATTER THIS WEEK.**

cc: Paul Dimond
Sheryll Cashin
Bruce Katz
Larry Parks
Lorraine Miller
Paul Carey

new investment areas or targeted populations, offering more services or increasing their volume of business. This will ensure that the funding process remains competitive and dynamic as individual community needs change.

In most cases, matching funds from another source on at least a 1:1 basis are required. Applicants must compete for available funds.

When can CDFIs to apply for assistance?

There will be some delay before the Fund starts to award assistance to CDFIs. President Clinton will nominate an Administrator who must, in turn, be confirmed by the Senate. Fund staff must be hired to draft and implement the rules and regulations under which the Fund will operate. Once administration for the Fund is in place, applications for assistance can be processed and assistance awarded on a competitive basis.

Other Provisions of the Act

- protect homeowners from exorbitant fees and unscrupulous practices by lenders
- improve the detection of money laundering
- reduce the regulatory and paperwork burden on our financial institutions, and streamline regulatory requirements
- help small businesses and those who help provide businesses with commercial real estate by removing barriers to backing securities with small business or commercial real estate loans

Prepared by:
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Community Development Financial Institutions: Fulfilling a Presidential Promise

September 23, 1994

Community Development Financial Institutions: Fulfilling a Presidential Promise

community investment
consumer protection
help for small businesses
streamlined regulation

What is CDFI?

The Community Development Banking and Regulatory Improvement Act of 1994, signed by President Clinton on September 23, is a landmark bill that will bring technical and financial assistance for community development to needy areas and populations.

The Act complements and builds on other legislation designed to empower communities through their local institutions, including the Bank Enterprise Act, Community Reinvestment Act, and the Second Mortgage Market Enhancement Act. Provisions of the new law are designed to help consumers, businesses, and banks.

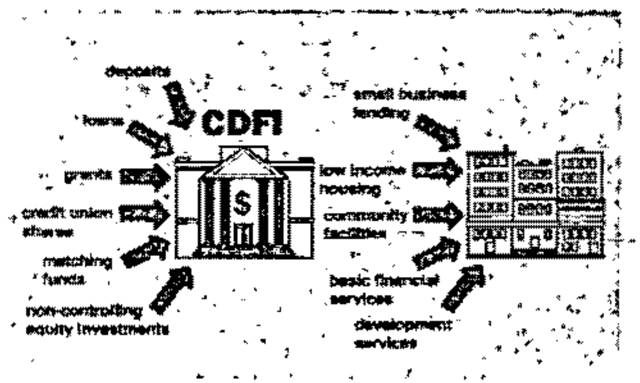
As much as $500 million will be available over four years to establish a Fund to which community development financial institutions (CDFIs) can apply, to finance the Bank Enterprise Act, and to administer the provisions of the Act. For Fiscal Year 1995, $125 million has been appropriated.

The CDFI Fund

Who can get help from the CDFI Fund?

The Act creates a new Fund to assist existing and newly-established community development financial institutions serving "investment areas" or "targeted populations":

- An **investment area** is a geographic area, including an Indian reservation, that meets objective criteria of distress developed by the Fund and has <u>significant unmet needs</u> for loans or equity investments or is located in an empowerment zone or enterprise community.
- A **targeted population** is individuals, or groups of individuals, including Indian tribes, who are low-income persons or otherwise lack adequate access to loans or equity investments.



A CDFI can be an efficient and effective vehicle for development. It may leverage Fund assistance with other funds from the private sector, and then lend the money out in its community. A CDFI may provide development services in conjunction with equity investments or loans. It must provide accountability to the area or population it serves, and may not be an agency of any government jurisdiction.

The Fund can also provide assistance to a "community partnership" between a CDFI and a "community partner." In this way a CDFI can work with an established entity such as a depository institution holding company, credit union, nonprofit organization, state or local government agency, or quasi-governmental entity. Assistance provided by the Fund to community partnerships can go only to the CDFI, not the community partner.

The Fund may provide:

- up to $5 million during a three-year period to any one CDFI and its affiliates;
- up to $3.75 million in additional assistance for a CDFI to establish an affiliate or subsidiary outside of the state or metropolitan area currently served by the CDFI;
- up to 5% of its funds to enhance the liquidity of CDFIs.

What will the application criteria for Fund assistance be?

At a minimum, the applicant must show that it is, or will be, a community development financial institution. It must have a comprehensive strategic plan documenting the needs of the investment area or targeted population and how it will address those needs.

As CDFI-funded organizations become an integral part of economic development efforts in communities across the country, <u>the Act also requires that those organizations grow</u>. To receive additional funds, they must show that they have <u>met their performance goals</u> and that they are <u>expanding to</u>

Bruce: most recent CD Bank
CRA Proposals

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File: CD Banks

MEMO TO: CDB Working Group

FROM: David Lebryk
Brian Mathis
Mark Bender

SUBJECT: Discussion of Major Issues Pertaining to Interstate Branching

This memo responds to the Working Group's request for an analysis of the major issues that are raised by both proponents and opponents of interstate branching. The need for this review is driven by the proposal that large bank holding companies (BHCs) would be required to establish subsidiary community development banks (CDBs) in return for which certain interstate branching rights would be provided.

The BHC Subsidiary Proposal

Specifically, the BHC option would require the larger BHCs to allocate some dollar amount to the establishment of subsidiary CDBs.[1] In return these BHCs would receive the right to branch interstate in states where: (1) statewide branching is permitted; (2) nonresident BHCs are currently operating, or would be permitted to operate, a banking subsidiary; and (3) the BHC holds a "sufficient amount" of "qualifying assets" which demonstrate a meaningful and quantifiable commitment to community development in distressed areas of the potential host state.[2] In short, the BHC must first demonstrate satisfactory CDB performance in a selected state, after which the parent could branch into that state if statewide branching were permitted and the BHC is or would be able to operate a subsidiary bank in that state.[3]

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[1] By way of example, the 50 largest BHCs could be required to make, and maintain, an equity investment of 3/4 of 1% of their total equity capital for the establishment of CDBs. This would provide about $1 billion in equity for new CDBs. If assets were leveraged at a conservative 10 times equity, these new CDBs would amount to $10 billion in asset size to start.

[2] The terms "sufficient amount" and "qualifying assets" would be subject to definition and determination in the enabling legislation.

[3] FRB data suggest that only two states (Hawaii and Montana) currently prohibit any form of interstate banking, while only four states (Arkansas, Illinois, Iowa, and Minnesota) still effectively prohibit statewide branching. At this point in time

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The BHC option might also provide certain rights directly to adequately-capitalized subsidiary CDBs. First would be the authority for adequately-capitalized CDBs located in distressed areas to invest in, deal in, or underwrite securities issued by small businesses located there, <u>and</u> to sell insurance in these distressed areas. Second would be the authority for adequately-capitalized and satisfactorily performing CDBs to themselves branch nationwide only into other economically distressed areas. The securities and insurance provisions would ensure the availability of "mainstream" financial services critically needed by businesses and residents of distressed areas; at the same time they would buttress safety and soundness by diversifying the risk and stabilizing the earnings of CDBs.[4] The branching provision would ensure that successful CDBs are able to export their expertise to other economically distressed areas; the CDBs would benefit from geographic diversification of risk, while distressed communities would benefit from additional skilled lenders.[5]

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these six states could not accommodate interstate branching for parent BHCs as suggested here.

[4] The securities underwriting provision should be seen as an important adjunct to the existing special authority of national banks, member banks, and BHCs to invest up to 10 percent of unimpaired capital and surplus in equity and debt of Community Development Corporations (CDCs) and Community Development Projects (CDPs). The securities proposal would permit a similar, targeted-area support of small businesses. In a similar manner, the insurance sales provision merely extends to the CDB authority to do what national banks in towns of 5,000 or less, mutual savings banks wherever located, and a large number of state banks already have authority to do (e.g., 17 states currently allow their state banks to brokerage insurance; 5 of these states additionally allow insurance underwriting). CDBs would focus insurance sales in distressed areas where the service is desperately needed.

[5] All of these provisions are made within context of the goals of the community revitalization program and are not unique to this proposal. For example, in recent Congressional testimony a representative of Shorebank Corporation stated that:

> Legislative action defines the permissible activities of these regulated institutions. These permitted activities could be orchestrated to better serve public purposes by allowing those depositories which are most responsive to public needs to also engage in other profit making activities that are now prohibited or curtailed. Interstate banking privileges, authorization to sell insurance, permission to underwrite securities, higher levels of deposit insurance, or other incentives ... could be provided

As requested by the Working Group, the remainder of this memo will examine the major arguments offered by the proponents and opponents of interstate branching.

Arguments in Favor of Interstate Branching

Eroding Effectiveness of Geographic Restrictions

Proponents of interstate branching argue that it is difficult to determine exactly what economic purpose is now served by restrictions on geographic diversification of bank offices. For one thing, banking organizations today simply cannot be defined in terms of the limited services and facilities appropriate to the McFadden era.[6] For another, there currently exist a wide range of non-bank institutions that offer close substitutes for bank products and operate unencumbered by geographic restrictions. On both sides of the balance sheet, the business of banking has now gone far beyond the restricted range of services underpinning McFadden.

On the liability side, banking organizations now fund themselves not only with local retail deposits, but with large negotiated certificates of deposit, brokered deposits, Eurodollar borrowings, foreign deposits, and debt issues. These funding sources can involve local, regional, national, and international financial markets. On the asset side also, banks long ago reached beyond strictly local markets for business and consumer loans. Real estate loans, commercial loans, foreign government loans, securitization of loan assets, and various types of loan participations typically require involvement in non-local markets. This is also true of other services such as cash management, electronic funds transfers, private placements, credit card distributions, and certain off-balance sheet activities.

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to banks engaged in public purpose lending. Such privileges, however, should only be granted to banks that meet a high hurdle of investment in low and moderate income communities.

See, statement of Robert M. Weissbourd, Vice President, Shorebank Corporation, before the House Subcommittee on Consumer Credit and Insurance, January 27, 1993, pg. 7.

[6] Section 7(f) of McFadden defined a "branch" to include "any branch office, branch agency, additional office, or any branch place of business located in any State or Territory of the United States or in the District of Columbia at which deposits are received, or checks paid, or money lent."

Even with respect to brick-and-mortar facilities, geographic restrictions have proven to be quite porous. For example, the loan production offices (LPOs) and Edge Corporations of banks are not limited by "home state" geographic restrictions. And bank holding companies have routinely offered financial services such as mortgage finance, consumer finance, and discount brokerage across state boundaries through subsidiaries. Also, certain interstate banking activities of bank holding companies and foreign banks were grandfathered in the Bank Holding Company Act of 1956 and the International Banking Act of 1978. Finally, bank holding companies were especially effective in the 1970s and 1980s at using networks of nonbank banks and acquired thrift institutions to establish interstate networks of limited and full service banking operations. In this respect it has been reported that "By year end 1988, ... 14,600 interstate offices of banking organizations were in operation, of which 7,500 could offer a full line of banking services and about 7,100 could offer limited banking services."[7]

Non-Bank Institutions. A significant number of non-bank financial institutions offer products that compete directly with bank services, yet these non-banks have never been forced into the inefficiencies that accompany geographic restrictions. Securities firms effectively compete for the funds of savers by offering insured brokered CDs as well as cash management accounts with check-writing and credit card features through large networks of geographically dispersed offices. Also, insurance companies provide a bank-like savings service. In effect, when the holder of a whole-life policy pays premiums a portion of each payment accumulates and earns interest as does a savings account. The policyholder is free to surrender the policy and "withdraw" its cash value. Or, a policyholder may borrow against the "loan value" of the policy at a modest interest rate and without obligation to repay: the policy loans of life insurance companies amounted to $57.4 billion at year-end 1989.[8] In these respects life insurers offer a service not unlike bank passbook savings accounts. In addition, it should be remembered that securities firms and insurance companies were major acquirors of "non-bank banks" until the passage of restrictive legislation in 1987.

Other major bank competitors that operate free of branching restrictions include consumer, business, and sales finance companies, mortgage companies, thrift institutions, the "captive finance" firms of automobile and appliance manufacturers, and retail credit grantors, among others.

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[7] Rose, Peter S., The Interstate Banking Revolution, Quorum Books, New York, 1989, pg. 13.

[8] American Council of Life Insurance, 1990 Life Insurance Fact Book, Washington, D.C., 1990, pg. 100.

Explanatory Factors. A number of factors help to explain the 1980s' trend towards fewer geographic restrictions on banks, most notably the adoption of interstate banking. The desire to attract and pool capital that could be used to support a state's economic growth and development was perhaps the major motivation for both statewide branching and interstate banking provisions. This appears to have been the case for states such as Maine, Delaware, South Dakota, and the states of the Southwest (such as Louisiana, Texas, and Oklahoma).[10]

Another major factor was the need to facilitate the resolution of troubled banks and thrifts by permitting acquisitions by institutions from outside of the state (provisions for which were contained in the Garn-St Germain Act of 1982).[11] For example, the majority of bank failures of the past years occurred in the Southwestern states of Arkansas, Louisiana, New Mexico, Oklahoma, and Texas. Since 1980, Texas and Oklahoma effectively shifted from unit banking to statewide branching. In addition, all of the Southwestern states except Arkansas now permit nationwide interstate banking; Arkansas permits interstate banking based on regional reciprocity. The importance of these changes in geographic restrictions for a state such as Texas was obvious from the Chemical Bank/Texas Commerce and NCNB/First RepublicBank transactions.

A third major factor explaining liberalization of geographic restrictions was the growing pressure exerted by the banking industry on state regulators to establish a "level playing field" for banks vis-a-vis their nonbank competitors.[12] As discussed above, numerous nonbank institutions compete with banks over a wide range of financial services without any geographic restrictions to contend with. More and more states have come to understand that artificially imposed geographic restrictions can only erode the competitive viability of the commercial banks their own economic vitality depends upon.

Safety and Soundness

All other considerations notwithstanding, a strong case

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in earnest.

[10] Rose, op. cit., pp. 25-28. Specifically, according to Rose, "..the desire to improve local economies and to stimulate local and regional economic development stands at the top of the list of causal factors behind interstate banking."

[11] Ibid., pp. 29-30.

[12] Ibid., pp. 30-31.

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generally can be made for any structural arrangement that enhances safety and soundness (or reduces risk) in the banking system because of the public's exposure to the costs of bank failures. The degree of risk of an activity is measured by the variability of the cash flow, revenue, or rate of return of that activity; to the extent this variability is suppressed, risk is reduced. In the case of commercial banking, diversification traditionally has been viewed as one of the most important elements of risk control (as opposed to deposit insurance which is fundamentally a mechanism for shifting risk from the institution and its depositors to the insurance fund).

In recent years, many of the proposals for financial institutions restructuring have relied in large part on the potential risk reduction benefits of diversification. For example, proponents of securities activities for commercial banks argue that there is a low correlation between the revenue flows from commercial loans and from securities underwriting activities, meaning that the variability of the combined flow of income from these activities would be less than that of either activity taken alone. This leads to the conclusion that permitting commercial banks to engage in full service securities activities would reduce overall risk (enhance safety and soundness) in the banking system.[13]

The diversification argument for expanded activities is easily transferred to the question of geographic location. In short, the earnings of commercial banks limited in geographic reach may be extremely susceptible to the vagaries of local market cycles due to the lack of diversification of traditional assets. Moreover, this risk will itself tend to vary inversely with the degree of diversification of the local market, or state economy. Proponents of interstate banking and branching argue that relaxing bank geographic restrictions will yield a combined income flow from different regions that is more stable than that

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[13] See, Rethinking Glass-Steagall, J.P. Morgan & Co. Incorporated, pp. 20-22. Specifically,

> Not only is the securities business more profitable than the banking business, but commercial bank entry into corporate securities activities would also allow banks to diversify their sources of revenue and reduce earnings volatility. ...for example, corporate bond issuance and the growth of bank commercial and industrial loans are negatively correlated. When corporate bond issuance is high, the demand for bank loans is low; when bank loan demand is high, bond sales tend to drop off. Thus involvement in the corporate securities business might well prove beneficial in enabling bank holding companies to even out swings in earnings associated with changes in loan demand. (pg. 12)

of each region individually. In this regard, a recent statistical study concluded that "a majority of states with failure rates above the national average are characterized by economies that are generally not well diversified;" and "the inability of banks to diversify their loan portfolios is partly responsible for the reported higher than average rate of bank failures in some states."[14]

Other empirical studies uniformly find that branch banks have historically had a better safety record than unit banks, which have no branches. An examination of the record of bank failures and the consequent behavior of the states in recent years confirms this. For example, during the 1970s, Texas banks were confined by state laws to a single full-service location, but were considered among the best-capitalized, most profitable banks in America. Ten years later, after severe problems with the energy economy, nine of the top ten had been reorganized with FDIC or other outside assistance. Appropriate regional diversification might have prevented some of these failures. As noted earlier, Texas has since adopted both statewide branching and nationwide banking.

Competition and Performance

Restrictions on branching, be they intrastate or interstate, represent barriers to market entry that may permit protected institutions to perform at less than competitive standards. Evidence of this could include higher profits, lower loan output, higher prices for financial services and products, reduced convenience for consumers, and lower interest rates paid on deposits, among others.

A large number of studies of the impact of branch banking on market structure and performance have been done over the years. For the most part these studies have found that ease of entry through branching improves performance; and, in particular, little or no evidence is found to support the arguments that branch banking will lead to a decline in the number of community banks and divert credit from local borrowers.

A comprehensive 1981 study of branching issues specifically examined the question of the impact of branching on banking markets in local communities.[15] After an examination of the evidence based on statewide branching, limited branching, and

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[14] Hawawini, Gabriel and Itzhak Swary, Mergers and Acquisitions in the U.S. Banking Industry: Evidence from the Capital Markets, North Holland, New York, 1990, pg. 62.

[15] U.S. Treasury Department, Geographic Restrictions on Commercial Banking in the United States, January 1981, Chapter 6.

unit banking states, it was concluded that broader branching authority brought with it "noticeable benefits" to local communities. These benefits took the form of greater consumer convenience through the availability of more bank offices and enhanced bank performance. In particular, broader branching authority was found to "result in increased potential competition and lower prices and other more liberal terms for bank loan services, higher deposit interest rates, greater loan output, and lower profits." Moreover, no evidence was found of either a restriction of credit to local borrowers or a decrease in the number of banking alternatives in local communities.

A more recent survey of the evidence on branching confirms most of the findings discussed above.[16] Of special interest is the fact that when commercial banks were grouped by size and branching status, using 1984 data, a consistent pattern emerged showing that (1) the loan-to-asset ratios of larger banks exceeded those of smaller banks, and (2) for all size categories, banks in statewide branching states had higher loan-to-asset ratios than their peer groups for the United States overall. Also, in an assessment of consumer convenience, measured by population per banking office, it was found that "unit banking states tend to service more persons per banking office than either limited or statewide branching states, indicating a relative lack of consumer convenience in unit banking states." Finally, branching was found to be a significant factor in promoting "more efficient" pricing of bank services.

Interstate branching can create additional unique conveniences for consumers, particularly those who frequently cross state lines for work or other reasons. Today, a customer with a bank account in one state typically cannot get full-service banking services from an affiliated bank in another state without opening a separate account; there would be no such problem with interstate branching. An interstate branching network would also make cash and banking services available to travelers.

Efficiency and Cost Savings

Briefly put, a financial intermediary is a mechanism for the collection and distribution (allocation) of funds. Banks (or other insured depositories) typically collect the greatest part

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[16] Scheld, Karl A. and Baer, Herbert, "Interstate Banking and Intrastate Branching: Summing Up," Toward Nationwide Banking: A Guide to the Issues, Federal Reserve Bank of Chicago, 1986, pp. 75-83.

of their funds from insured and uninsured depositors; the remainder comes from other creditors/debtholders and equity investors. In turn these funds are allocated to commercial, consumer, or housing loans (the mix depending upon the relative specialization of the institution). The expenses of the bank are twofold in nature: First, the cost of collected funds which is largely determined by market interest rates (and is known as interest expense IE). Second, all of the ancillary costs of operating the bank including employees, information processing, transactions costs, maintenance of brick and mortar facilities, management and administration, regulatory compliance, legal and advertising costs, and so on (all of which are known as noninterest expense NIE).

Cost savings from commercial bank branching are generally estimated at two different levels of aggregation. In the first case, nationwide branching is viewed as facilitating the consolidation of the overall banking system through mergers and acquisitions. It is argued that if overall consolidation is characterized by efficient firms acquiring inefficient firms substantial reductions in NIE can be realized for the entire banking system. In the second case, a reduced level of interstate branching would be designed to allow multibank firms operating in several states to consolidate their subsidiary banks into a branch banking system. The nature of the cost savings would be identical to that of nationwide branching, but the overall magnitude of those savings clearly would be less.

<u>Estimated Consolidation Savings</u>. Analysis offered by McKinsey & Company strongly supports the notion of cost savings through bank consolidation.[17] It is argued that the combined noninterest expenses (NIE) of merged institutions can be reduced by 20 to 25 percent of premerger levels, "half of the saving comes from the salaries and benefits of redundant employees; the remainder comes from closing [redundant] branches and reducing the cost of rent, office equipment, systems, marketing and professional services." According to this analysis, tremendous excess capacity in the banking industry nationwide, manifested in large ($120 billion) and growing (10 percent per year) NIE, is at the heart of the problem. Elimination of this excess capacity suggests that NIE "could easily fall by $10 billion to $15 billion!" Finally, this analysis holds that total industry savings of $15 billion per year "could add more than $45 billion

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[17] Mendoca, Larry, "Done Right, Bank Mergers Can Save Money," <u>Wall Street Journal</u>, May 13, 1992. (The McKinsey findings essentially represent an extrapolation of observations made on a few large institutions to the overall banking industry.)

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to the industry's market value."[18] If a reduced level of branching is considered, that is, interstate branching for the multibank holding companies now operating interstate, McKinsey estimates total annual cost savings ranging from a low of $416 million to a high of $813 million (with a midpoint of $624 million).

A recent academic study of the branching/consolidation issue provides conceptual and analytical support to the McKinsey analysis.[19] This study finds evidence of a substantial dispersion in bank costs in all bank size categories. In fact, after grouping banks in four cost quartiles, it was found that "the highest cost quartile of banks have average costs that are 23% higher than those of the lowest quartile," a difference largely accounted for by variations in efficiency. It follows

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[18] In a separate publication, another McKinsey representative has made the case with respect to noninterest expenses as follows:

> Whenever we at McKinsey have analyzed non-interest expenses in an individual bank, we have seen that the links to revenues are tenuous indeed. Typically, we find that some 20 percent to 30 percent of expenses are for pure overhead and control functions (that is, expenses that contribute neither to attracting nor serving customers -- such as finance or personnel departments, auditors, and the like). Another 20 percent to 25 percent are for shared distribution expenses -- in particular, branches. Another 20 percent to 30 percent are for shared operating expenses. Only the remaining 15 percent to 20 percent can be attributed to bringing in specific customers and actually delivering services. (pg. 44)

> Furthermore:

> ... our analysis of a broad cross section of the industry has shown that large regional banks can operate at significantly lower costs than a smaller regional with the same customer mix. For example, we estimate a $20-billion regional bank might have operating costs as a percentage of assets of 2.5 percent to 3.0 percent, whereas a $3- to $4-billion regional bank might have operating costs as a percentage of assets of 3.5 percent to 4.0 percent. (pg. 85)

See, Bryan, Lowell L., Bankrupt: Restoring the Health and Profitability of Our Banking System, Harper Business, 1991.

[19] Humphrey, David Burras, "The Likely Effects of Interstate Branching on Bank Costs and Service Prices," Prepared for the Congressional Budget Office, October 1991.

that to the extent interstate branching fosters the absorption of inefficient banks by efficient banks, total banking system costs might be reduced. The overall magnitude of cost savings was estimated to be around 3% to 4%, depending upon the degree to which the performance of inefficient banks could be made to match the overall mean or the second lowest quartile of banks, respectively. (These results were found to be reasonably compatible with McKinsey's implied 3% to 6% savings in total systemwide banking industry costs).

Even the Conference of State Bank Supervisors (CSBS), in an effort to diminish the importance of cost savings through branching, estimated that annual savings through branching might amount to "only" $2 billion. But this is not a meaningless sum of money -- over ten years it would amount to $20 billion, a good portion of which would show up in strengthened capital for banks.

Arguments in Opposition to Interstate Branching

Consolidation of Small Banks

One of the most frequently heard arguments against interstate branching is that it will inevitably lead to a decline in the number of small banks. The premise of this argument is that permitting the entry of large institutions into local, protected markets will result in the "driving out" or "buying out" of small community banks. However, there is ample evidence that this is not an inevitable outcome. For example, in states where branching restrictions were significantly relaxed in recent years, such as New York, small banks have continued to prosper. And when Maine opened itself up for interstate banking, Citicorp established a de novo bank in Portland in 1984. By mid-1989, Citicorp/Maine had captured less than 3 percent of total commercial bank, savings bank, and savings and loan association deposits. Overall, fears about the viability of small banks and the maintenance of competition in the face of relaxed geographic restrictions do not appear to have an empirical base.

Furthermore, even in states that have long had liberal branching laws, small banks more than hold their own. For example, both North and South Carolina have statewide branching laws of long standing. Nevertheless, in 1991, in North Carolina 68 out of a total of 78 banks had assets of less than $500 million; in South Carolina 78 out of a total of 84 banks had assets of less than $500 million.

The vast majority of small banks are actually among the most profitable and best-capitalized banks in the nation. These financially strong banks are quite capable of continued survival in the face of nationwide banking and branching, provided their owners are committed to maintaining their independence. On balance, it may be true that interstate branching will assist in the needed consolidation of weak banks of whatever size; but it will not mean the automatic consolidation of well-capitalized and well-managed small banks.

End of Dual Banking System

It is also claimed by opponents of interstate banking and branching proposals that such measures would damage the dual banking system beyond repair. For one thing, it is said that the states would be effectively "stripped" of their ability to impose terms and conditions on the operations of banks within their borders. But this is just not the case. All of the major legislative proposals of recent years deferred to the states in a large number of important ways. Most importantly, states retained the right to govern intrastate branching, for both national and state banks; and they retained their control over the interstate branching privileges of their own state banks. In addition, most proposals granted "host states" the right to limit the activities of the branches of out-of-state banks, national banks excepted, to no more than the activities allowed their own in-state banks. Moreover, interstate branching proposals typically yielded to the states on the issue of requiring national bank compliance with local state laws regarding fair lending practices, state capital requirements, unsafe and unsound banking practices, community reinvestment requirements, and state taxation.[20]

No Local Reinvestment

Another argument often made by opponents of interstate branching is that it will undermine the intent of the Community Reinvestment Act of 1977 (CRA) and lead to a "siphoning off" of funds from local markets. But there is simply no firm evidence that branch banks are more inclined than other banking organizations to "siphon off" funds from local communities. To the contrary, numerous studies over the past decade suggest that bank expansion can result in a greater proportion of loans to local customers than where bank expansion is limited. Typically, banks have higher loan-to-asset ratios -- that is, employ a greater proportion of their resources for loans -- when they

[20] There does not appear to be any authority that would accord states a lesser right to tax in-state activities of a national or state bank that has its home office in another state. In particular, section 548 of Title 12 of the U.S. Code, which addresses state taxation of national banks, does not indicate that national banks are to be treated differently than other corporations in this respect.

operate in broader branching states than in restricted branching states.

Furthermore, it must be recognized that the "siphoning off" of funds is really not unique to branch banking. For example, a bank not wishing to lend in its local area could sell federal funds upstream to a correspondent bank, partake in loan participations, or put its funds into investment securities rather than loans.

Finally, the argument that branches suck credit out of a region is a two-edged sword: The ability to draw credit out of an area implies the ability to inject credit into an area, so branches are as likely to bring funds into local communities as to take funds out (which was one of the major reasons for states moving to liberal branching laws).

Concentration of Resources

A long-standing concern with respect to the removal of geographic restrictions involves the potential impact on the concentration of banking resources. Critical to any assessment of concentration, however, is the definition of market used. Results will typically vary depending upon whether the market is defined as local (SMSAs), regional, statewide, or national. The competitive implications of most bank mergers in the U.S. are still evaluated in terms of their potential impact on local markets, both urban and rural. Local concentration is typically measured by three-firm concentration ratios, i.e., the share of total bank assets or deposits in a given local area (normally a Metropolitan Statistical Area, MSA) held by the top three firms. In this respect, the data show that concentration in local urban and rural markets remained virtually unchanged between 1976 and 1991. In spite of the fact that concentration at the relevant local market level remains far from worrisome, a number of states have enacted deposit concentration limits.[21] It is important to note that the BHC subsidiary option would not override state concentration limits.

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[21] Although concentration at the local market level remains largely unchanged for many years now, sixteen states have nevertheless implemented caps on deposit share (Arkansas, Colorado, Iowa, Kansas, Kentucky, Massachusetts, Missouri, Mississippi, North Dakota, Nevada, Ohio, Oklahoma, New Hampshire, Tennessee, Texas, and West Virginia). These caps range from a low of 10 percent to a high of 25 percent; and the caps vary from including commercial bank deposits only to including the deposits of all depository institutions. And Senator Dodd's "Interstate Banking and Branching Act of 1993" (S. 371) includes both nationwide (no more than 10 percent) and statewide (30 percent or more) asset caps.

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Moreover, banks compete with other insured depositories and non-depository financial intermediaries across a broad range of activities, and these other bank competitors are not represented in simple ratios on concentration of bank assets or deposits. Indeed, in recent years the federal bank regulators and the antitrust enforcement agencies have been attempting to redefine relevant product and geographic markets to better accommodate the competitive impact of non-regulated financial services providers.

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Summary of State Bank Expansion Laws (1992)

Intrastate Branching

- 47 states (including District of Columbia) currently have laws permitting statewide branching.

- 4 states have laws that permit limited (county or parish) branching (AK, IL, IA, MN).

Interstate Banking

- 12 states have enacted national non-reciprocal interstate banking laws (AK, AZ, CO, ID, ME, NV, NM, OK, OR, TX, UT, WY).

- 22 states have enacted national reciprocal interstate banking laws (CA, CT, DE, IL, IN, KY, LA, MA, MI, NE, NH, NJ, NY, ND, OH, PA, RI, TN, SD, VT, WA, WV).

- 15 states (including District of Columbia) have enacted regional reciprocal interstate banking laws (AL, AR, DC, FL, GA, IA, KS, MD, MN, MS, MO, NC, SC, VA, WI).

- 2 states continue to prohibit interstate banking (Hawaii and Montana).

Interstate Branching

- As a general matter, no state currently permits interstate branching.

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INTERSTATE BANKING LEGISLATION BY STATE
(AS OF JANUARY 1, 1993)

STATE	LEGISLATION IN EFFECT	AREA
Alabama	Currently	Reciprocal. 13 States and DC (AR, FL, GA, KY, LA, MD, MS, NC, SC, TN, TX, VA, WV, DC)
Alaska	Currently	National, no reciprocity.
Arizona	Currently	National, no reciprocity.
Arkansas	Currently	Reciprocal. 16 States and DC (AL, FL, GA, KS, LA, MD, MO, MS, NC, NE, OK, SC, TN, TX, VA, WV, DC)
California	Currently	National, reciprocal.
Colorado	Currently	National, no reciprocity.
Connecticut	Currently	National, reciprocal
Delaware	Currently	National, reciprocal
District of Columbia	Currently	Reciprocal. 11 States (AL, FL, GA, LA, MD, MS, NC, SC, TN, VA, WV)
Florida	Currently	Reciprocal. 11 States and DC (AL, AR, GA, LA, MD, MS, NC, SC, TN, VA, WV, DC)
Georgia	Currently	Reciprocal. 10 States and DC (AL, DC, FL, KY, LA, MD, MS, NC, SC, TN, VA)
Idaho	Currently	National, no reciprocity.
Illinois	Currently	National, reciprocal.
Indiana	Currently	National, reciprocal.
Iowa	Currently	Reciprocal. 6 States (IL, MN, MO, NE, SD, WI)
Kansas	Currently	Reciprocal. 6 States (AR, CO, IA, MO, NE, OK)
Kentucky	Currently	National, reciprocal.
Louisiana	Currently	National, reciprocal.

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STATE	LEGISLATION IN EFFECT	AREA
Maine	Currently	National, no reciprocity.
Maryland	Currently	Reciprocal. 14 States and DC (AL, AR, DE, FL, GA, KY, LA, MS, NC, PA, SC, TN, VA, WV, DC)
Massachusetts	Currently	National, reciprocal.
Michigan	Currently	National, reciprocal.
Minnesota	Currently	Reciprocal. 16 States (CO, IA, ID, IL, IN, KS, MI, MO, MT, ND, NE, OH, SD, WA, WI, WY)
Mississippi	Currently	Reciprocal. 13 States (AL, AR, FL, GA, KY, LA, MO, NC, SC, TN, TX, VA, WV)
Missouri	Currently	Reciprocal. 8 States (AR, IA, IL, KS, KY, NE, OK, TN)
Nebraska	Currently	National, reciprocal.
Nevada	Currently	National, no reciprocity
New Hampshire	Currently	National, no reciprocity
New Jersey	Currently	National, reciprocal.
New Mexico	Currently	National, no reciprocity.
New York	Currently	National, reciprocal.
North Carolina	Currently	Reciprocal. 13 States and DC (AL, AR, FL, GA, KY, LA, MD, MS, SC, TN, TX, VA, WV, DC)
North Dakota	Currently	National, reciprocal.
Ohio	Currently	National, reciprocal.
Oklahoma	Currently	National. After initial entry, BHC must be from state offering reciprocity or wait 4 years to expand.
Oregon	Currently	National, no reciprocity.
Pennsylvania	Currently	National, reciprocal
Rhode Island	Currently	National, reciprocal.

DRAFT

STATE	LEGISLATION IN EFFECT	AREA
South Carolina	Currently	Reciprocal. 12 States and DC (AL, AR, FL, GA, KY, LA, MD, MS, NC, TN, VA, WV, DC)
South Dakota	Currently	National, reciprocal.
Tennessee	Currently	National, reciprocal.
Texas	Currently	National, no reciprocity.
Utah	Currently	National, no reciprocity.
Vermont	Currently	National, reciprocal
Virginia	Currently	Reciprocal. 12 States and DC (AL, AR, FL, GA, KY, LA, MD, MS, NC, SC, TN, WV, DC)
Washington	Currently	National, reciprocal.
West Virginia	Currently	National, reciprocal.
Wisconsin	Currently	Reciprocal. 8 States (IA, IL, IN, KY, MI, MN, MO, OH)
Wyoming	Currently	National, no reciprocity.

Note: Several states prohibit acquisition of banks in operation for less than a specified number of years.

Source: Financial Structure Section, Board of Governors of the Federal Reserve System.

DRAFT

BHC Interstate Operations

- Thirty-nine of the top 50 BHCs in terms of assets have interstate banking offices.

- Forty-five states plus the District of Columbia contain banks owned by at least one of those 39 BHCs that have interstate operations.

- Five states contain neither an out-of-state BHC (from the list of 39 BHCs that have interstate operations) nor the home office of any of the top 50 BHCs.

  -- These states are: Arkansas, Kansas, Louisiana, Mississippi and West Virginia.

March 17, 1993

DRAFT

S. 371 -- Interstate Banking and Branching Act (Dodd)

Summary of Major Provisions

- Provides for nationwide interstate banking via acquisitions of existing banks by BHCs effective 1 year after enactment; and by establishment of new banks effective 2 years after enactment.

  -- Acquisitions are prohibited if the applicant controls, or upon completion of the acquisition would control, more than 10 percent of insured depository institution assets nationwide; or 30 percent or more of insured depository institution deposits in the state in which the bank to be acquired is located.

- Beginning 18 months after enactment multistate BHCs may consolidate interstate banks into branches (unless prohibited by the host state).

- Beginning 3 years after enactment banks are permitted to branch interstate.

  -- Interstate branches are subject to the laws of the host state with respect to intrastate branching, consumer protection, fair lending, community reinvestment, and nondiscriminatory franchise (or other nonproperty) taxes.

  -- Host states may require all banks using this branching provision to comply with nondiscriminatory filing requirements.

  -- State banks may not conduct any activity at their interstate branches that is not permissible for a bank chartered by the host state.

  -- The concentration limits applicable to BHC acquisitions also are applicable to branch acquisitions.

  -- State banks chartered by, and national banks with their main office in states that do not permit interstate branching may not themselves branch interstate.

- Within 3 years of the date of enactment a state may elect to "opt out" of interstate branching through law that expressly prohibits all out-of-state national and state banks from acquiring or establishing branches in that state. (This election may at any time be reversed by the state.)

DRAFT

- During the 3-year period following enactment a national bank may establish an interstate branch provided that the prospective host state has specifically enacted legislation permitting the establishment of branches by all out-of-state national and state banks.

- Foreign banks are provided "national treatment" with respect to interstate branching.

- The appropriate federal regulator must make a written evaluation of the entire institution's CRA performance; and again for each state where the institution has a branch.

DRAFT

H.R. 459 -- Nationwide Banking and Branching Act (Hoagland)

Summary of Major Provisions

- Provides for nationwide interstate banking via subsidiaries by BHCs or foreign banks effective with enactment.

- Beginning two years after enactment banks are permitted to branch interstate (national banks subject to specific consideration of CRA ratings).

  -- Host states may require all banks using this branching provision to comply with nondiscriminatory filing requirements.

  -- State banks may not conduct any activity at their interstate branches that is not permissible for a bank chartered by the host state.

- Within two years of the date of enactment a state may elect to prohibit interstate branching through law that expressly prohibits all out-of-state national and state banks from acquiring or establishing branches in that state. (This election may at any time be reversed by the state.)

  -- State banks chartered by host states that do not pernit interstate branching may not themselves branch interstate.

- During the two-year period following enactment a national bank may establish an interstate branch provided that the prospective host state has specifically enacted legislation permitting the establishment of branches by all out-of-state national and state banks.

- Host state regulatory authorities may examine out-of-state bank branches to determine compliance with host state laws.

- Host state taxation authority is not compromised by interstate branching provisions.

- Multistate BHCs are authorized to combine subsidiary banks into a single bank two years after enactment and subject to the branching restrictions of host states.

  -- States may "opt out" of this consolidation provision.

- Foreign banks are provided "national treatment" with respect to interstate banking and branching.

- The appropriate federal regulator must make a written evaluation of the entire institution's CRA performance; and again for each state where the institution has a branch.

DRAFT

H.R. 256 -- The Bank Efficiency Act (Neal)

Summary of Major Provisions

- BHCs with banking subsidiaries in more than one state could combine two or more of them into a single bank.

- States can "opt out" of this provision if they specifically enact legislation to do so within two years of enactment of H.R. 256.

- If any bank resulting from the provisions of H.R. 256 ceases to be a subsidiary of a BHC it shall, within two years of termination of its subsidiary status, no longer be entitled to the benefits of this law and must comply with all provisions of state and federal law regarding branching.

- All branches resulting from a combination under H.R. 256 can be retained; and intrastate branching would be subject to state law.

- The host state regulator may independently determine whether an activity of an out-of-state branch of a state bank is permissible. (State authority does not reach to the permissible activities of national banks.)

- A state bank resulting from a combination would only be subject to the examination and supervision of the chartering state. However, the home and host states may enter into a cooperative agreement to facilitate supervision of the bank and its branches.

MARKET SHARE CAPS: A STATE-BY-STATE ROUNDUP

State	Limit on deposit share	Based on deposits at: Banks	Thrifts	Credit unions	Legislative status
Arkansas	25%	•			Recently raised from 15%
Colorado	25	•	■	♦	Passed in 1988. Applies to out-of-state banks only; no change foreseen
Iowa	10	•	■	♦	Bill pending to either raise or eliminate cap
Kansas	12	•			Legislation in progress that would raise cap to 18%
Kentucky	15	•	■	♦	Raised in July 1992 from 15% of bank deposits only
Massachusetts	15	•			Passed in 1990; no change foreseen
Missouri	13	•	■	♦	Informal expansion proposal rejected last year; further proposals expected
Mississippi	19	•	■	♦	Passed in July 1990; no change foreseen
North Dakota	19	•	■	♦	For out-of-state banks only. Passed in 1991; no change foreseen
Nevada	14	•	■		No change foreseen
Ohio	20	•	■		No change foreseen
Oklahoma	11	•	■	♦	Expansion proposal seen as likely
New Hampshire	20	•	■	♦	Raised from 15% in 1990; no change foreseen
Tennessee	16.5	•	■	♦	No change foreseen

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State	Limit on deposit share	Based on deposits at: Banks	Thrifts	Credit unions	Legislative status
Texas	25	*			Passed in 1987; no change foreseen
West Virginia	20	*	■	♦	No change foreseen

Explanatory Factors. A number of factors help to explain the 1980s' trend towards fewer geographic restrictions on banks, most notably the adoption of interstate banking. The desire to attract and pool capital that could be used to support a state's economic growth and development was perhaps the major motivation for both statewide branching and interstate banking provisions. This appears to have been the case for states such as Maine, Delaware, South Dakota, and the states of the Southwest (such as Louisiana, Texas, and Oklahoma).[10]

Another major factor was the need to facilitate the resolution of troubled banks and thrifts by permitting acquisitions by institutions from outside of the state (provisions for which were contained in the Garn-St Germain Act of 1982).[11] For example, the majority of bank failures of the past years occurred in the Southwestern states of Arkansas, Louisiana, New Mexico, Oklahoma, and Texas. Since 1980, Texas and Oklahoma effectively shifted from unit banking to statewide branching. In addition, all of the Southwestern states except Arkansas now permit nationwide interstate banking; Arkansas permits interstate banking based on regional reciprocity. The importance of these changes in geographic restrictions for a state such as Texas was obvious from the Chemical Bank/Texas Commerce and NCNB/First RepublicBank transactions.

A third major factor explaining liberalization of geographic restrictions was the growing pressure exerted by the banking industry on state regulators to establish a "level playing field" for banks vis-a-vis their nonbank competitors.[12] As discussed above, numerous nonbank institutions compete with banks over a wide range of financial services without any geographic restrictions to contend with. More and more states have come to understand that artificially imposed geographic restrictions can only erode the competitive viability of the commercial banks their own economic vitality depends upon.

Safety and Soundness

All other considerations notwithstanding, a strong case

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in earnest.

[10] Rose, op. cit., pp. 25-28. Specifically, according to Rose, "..the desire to improve local economies and to stimulate local and regional economic development stands at the top of the list of causal factors behind interstate banking."

[11] Ibid., pp. 29-30.

[12] Ibid., pp. 30-31.

THE WHITE HOUSE

WASHINGTON

March 18, 1993

MEMORANDUM FOR Konrad Alt
Janice Booker
Bill Bowden
Steve Cross
Bruce Katz
Gene Ludwig

FROM: Peter Yu
National Economic Council

SUBJECT: CRA Reform Proposals

This memorandum, based in part on thoughtful comments by Gene Ludwig and Steve Cross, presents two options for CRA reform. The first involves a new CAMEL-type CRA evaluation regime; the second is more modest and involves improvements in CRA enforcement practices. The background principles informing these options are set forth in the attached memorandum, which most of you received last week.

I offer these proposals primarily as a conversation-starter---in the hope of generating ideas about how to fulfill the President's campaign pledge to "substitute performance for paperwork." As our timeline is quite short, I greatly appreciate your participation and input.

I. Option 1: A CRA Performance Evaluation Program

Under this option, the regulators would establish a CRA performance evaluation system that (i) was based largely on objective and quantifiable factors, (ii) resembled the CAMEL system in its structure and operation, and (iii) was enforced through revised powers and practices.

A. *The Performance Evaluation Factors*

The revised system would look to five factors measuring CRA-relevant activity: (1) lending practices, (2) community development activities, (3) financial services, (4) branching practices, and (5) other activity. An examiner would evaluate an institution on each of these factors, assigning a rating of 1 to 5 for each factor.

Each factor would be designed to focus attention on the actual *performance* of the institution, and not on either the paperwork accumulated in support of the institution's efforts, the institution's "communication" with the community, or the involvement of the institution's directors. In short the revision would reject the approach implicit in Factors A, B, and C of the current scheme.

In order to limit examiner discretion in the assignment of ratings for the first four factors, and in order to maximize the comparability of these ratings, factor ratings would be determined by the following matrices.

Factor 1: Lending practices

The examiner would first identify the relevant type of lending: *e.g.*, mortgage, other property-related, consumer, or commercial. Then the examiner would compare the rate of extension of credit in low- and moderate-income tracts with the corresponding rate in higher-income tracts. (This is an extension of current Factor E.)

Rating 1 -- Ratio of 0.75 or higher
Rating 2 -- Ratio of 0.60-0.74
Rating 3 -- Ratio of 0.50-0.59
Rating 4 -- Ratio of 0.25-0.49
Rating 5 -- Ratio of 0.24 or lower

The examiner would also review the bank's compliance with anti-discrimination laws and regulations such as the ECOA and the Fair Housing Act. A finding of discrimination would result in a 2-point reduction in the bank's "lending practices" factor rating. (This incorporates the current Factor F.)

The examiner could also weigh the bank's participation in government-sponsored loan programs, such as guaranteed or subsidized loans for housing, small businesses, or small farms. Based on this evaluation, an examiner could increase the initial "lending practices" factor rating by up to 2 points. (This builds on current Factor J.)

Factor 2: Community Development

Community development activity may take many forms: equity investments, loans, or grants to CD banks, corporations, or credit unions, revolving loan funds, or microloan funds. The examiner would first examine the monetary aspect of such activity, determining the amount of such activity as a percentage of total equity capital, and then assigning a rating for this factor as follows:

Rating 1 -- 0.75% or more of total equity capital
Rating 2 -- 0.60-0.74% of total equity capital
Rating 3 -- 0.50-0.59% of total equity capital
Rating 4 -- 0.25-0.49% of total equity capital

Rating 5 -- 0.24% or less of total equity capital

The examiner could also consider non-monetary support of community development institutions (or activity) such as in-kind contributions or technical assistance. The examiner could also weigh the character of the bank's participation in community development (*e.g.*, whether the bank assumed a leadership role). Based on these considerations, the examiner could adjust the initial rating by no more than 2 points. (This analysis builds on current Factor H.)

Factor 3: Access to Banking: Financial Services

Basic "lifeline" banking services are critical to community reinvestment and "whole-community" banking. Under the revised system, an examiner would compare the bank's market penetration in these service areas in low- and moderate-income areas with penetration in higher-income areas. The examiner would assign the following ratings, based on the ratio of penetration in these tracts:

Rating 1 -- Ratio of 0.75 or higher
Rating 2 -- Ratio of 0.60-0.74
Rating 3 -- Ratio of 0.50-0.59
Rating 4 -- Ratio of 0.25-0.49
Rating 5 -- Ratio of 0.24 or lower

The examiner could also consider other factors influencing bank services, including the bank's financial condition and size, and the economic conditions in the community. Based on this evaluation, the examiner could adjust the initial rating by no more than 2 points. (This factor is related to Factor K in the current scheme.)

Factor 4: Access to Banking: Branching Practices

Access to banking services is determined in large part by bank branching practices. Because of differences in population density, branches per capita is an imperfect measure of bank access. Accordingly, the examiner would compare the "teller-equivalents" per population, counting both tellers and automatic-teller machines. Again, the examiner would compare low- and moderate-income neighborhoods with higher-income neighborhoods, and assign ratings as follows:

Rating 1 -- Ratio of 0.75 or higher
Rating 2 -- Ratio of 0.60-0.74
Rating 3 -- Ratio of 0.50-0.59
Rating 4 -- Ratio of 0.25-0.49
Rating 5 -- Ratio of 0.24 or lower

The examiner could also consider the mix of branches and machines, the precise locations of branches, the bank's policies toward branch closings, the hours of operation, and other factors affecting access to banking services. Based on these considerations, the examiner could adjust the initial rating by no more than 2 points. (This is related to current Factor G.)

Factor 5: Other Considerations

There are, of course, many ways in which a bank may reinvest in its community. Accordingly, Factor 5, which permits consideration of those activities, is open-ended. As stated in the current Factor L, these activities could include "working with affiliate organizations" or "providing branch sites for minority- or women-owned depository institutions on favorable terms." However, contrary to Factor L, standard charitable contributions would not be weighed in determining a rating on this factor.

B. The Composite Evaluation Rating

Just as in the CAMEL system, there would be no fixed formula, no simplistic mechanism for aggregating the five performance factors. However, unlike CAMEL, the new CRA evaluation system would include several prohibitions:

- a bank with one factor rating of 5 could not receive a composite rating of 1; a bank with two ratings of 5 could not receive a composite rating of 2; and a bank with three ratings of 5 could not receive a composite rating of 3.

Conversely,

- a bank with three factor ratings of 1 could not receive a composite rating of 5; a bank with four ratings of 1 could not receive a composite rating of 4; and a bank with five ratings of 1 could not receive a composite rating of 3.

These limitations would both constrain examiner discretion and provide certainty for institutions and community groups.

C. Enforcement Reforms

This revised performance-evaluation regime would be accompanied by revised enforcement policies. As with CAMEL ratings, the regulators' first priority is the effective surveillance of banks requiring special attention. Thus, banks with a composite CRA evaluation score of 1 or 2 would only be examined for CRA compliance *every 24 months*; other banks would be examined *every 12 months*. Moreover, the regulators would establish a schedule of civil money penalties to be paid by banks receiving composite CRA evaluation ratings of 5 or receiving composite ratings of 4 for an extended period of time.

D. Assessment and Comments

- This system would improve upon the current system by (i) focusing on performance and achievements rather than paperwork and deliberative processes, (ii) providing for inter-institution comparability; (iii) using the frequency of evaluations as an incentive; (iv) providing a less blunt enforcement mechanism (penalties).

- A more quantitative approach is attractive to banks because it (i) provides banks with clear guidance, (ii) reduces paperwork burdens, and (iii) employs a familiar methodology (CAMEL-type analysis).

- A more quantitative approach is attractive to community groups because it (i) prevents excessive "grade inflation," (ii) incorporates the most meaningful of the existing factors, and (iii) ensures that CD activity is not a substitute for CRA compliance.

- This approach is attractive to the regulators because it (i) leaves certain discretion to the examiners, and (ii) avoids the artificial precision of a point system.

- Notably, this arrangement offers banks *some* CRA credit for CD bank participation, but would prevent banks from obtaining a high CRA rating simply by making such a contribution. Also this system minimizes the banks' criticism that CRA is credit allocation: only one of the factors turns solely on lending practices and that factor is broadly defined.

E. Remaining Questions

Assuming we pursue Option 1, or some version thereof, there remain several open questions:

1. Can Option 1 (including the civil money penalties) be implemented by regulation, or is legislation required?

2. What are the paperwork burdens involved in geocoding data for the "lending practices" factor analysis?

3. How should "low- and moderate-income areas" be defined? By 80% AMI?

4. Should comparisons be made based on race or ethnicity rather than (or in addition to) income?

5. Is it sound to focus on only one type of lending per bank in regard to the "lending practices" factor?

6. How will this evaluation system work for rural banks?

7. How should one measure lending in the "lending practices" factor? By dollars extended per person? (This would seem inappropriate as poor areas have lower credit needs.)

8. What is the current level of bank investment in or lending to CD financial institutions? (Such information would help set the rating thresholds for Factor 2.)

9. How should boutique banks be treated in a revised CRA regime?

10. How should wholesale banking specialists be treated in a revised CRA regime?

OPTION 2: ENHANCING CRA ENFORCEMENT PRACTICES

A. *Proposed Enhancements*

A second option for CRA reform would involve extensive revisions to current enforcement practices, including:

- *Increased examiner specialization*—One shortcoming of the existing system is the examiners' lack of experience in CRA examinations. The regulators would redress this situation by concentrating responsibility for CRA examinations among a limited class of examiners and establishing special training sessions for those examiners.

- *Enhanced leadership*—The leadership of the regulating agencies would emphasize, through directives and actions, the importance of CRA compliance. The President may use his bully pulpit to reinforce this message.

- *Enhanced penalties authority* —As discussed above, the regulators would establish a schedule of civil money penalties for CRA noncompliance.

B. *Assessment and Comments*

This option reflects the observation that "we've never seen what CRA enforcement under a Democratic administration would look like." This option would likely be easier to implement than Option 1, but its efficacy is less certain. Moreover, the option does not address either bank or community group concerns concerning CD banking.

To: President's Working Group on Community Lending

From: The Nature and Scope Sub-Task Force

Re: The Nature and Scope of the Community Lending Problem

Introduction

The Subcommittee is charged with providing rhetoric and data on the nature, scope and definition of the credit problem faced by lower income Americans particularly those living in central cities and rural areas. The group is currently trying to amass statistical data on the credit problem. Below please find an annotated outline which describes why the CDFI concept is necessary; what is the nature of the credit problem for lower income communities; and why the solution should include capital access and technical assistance.

Discussion

I. Why Community Banks

A. Market failure

1. Definition of the need for access to credit
   a. 20 million American households have no relationship with a bank;
   b. 60% increase in pawnshops;
   c. explosion of expensive check cashing businesses;
   d. working capital for urban entrepreneurs generally found in factors that charge significant premiums.

2. Government policies encouraged the decline of the communities
   a. FHA policies
   b. Enforcement of CRA

3. Job seekers live in these communities with few job opportunities;
   a. statistics on number of applicants for limited number of new business start-ups in working class and poor communities;
   b. statistics on reverse commuting for entry level jobs in suburbia by urban and rural families;
   c. number of urban and rural residents enrolled in Job Corps and JPTA.

B. Racial Discrimination

1. Historical relationship of Banks and minority communities
2. Data on business formation and mortgage lending in minority communities
3. Redlining and other formal and informal lending

policies towards minority communities.

C. Government assistance to the low income;
1. New age Democratic policies to work with business to deliver assistance to low income communities;
2. Goal is to provide the poor with a ladder toward self-determination;
3. In a time of scarce resources, less expensive way to provide assistance;
4. Provides a tool that enables empowerment.

D. Government created obstacles for business formation and mortgage lending;
1. How government neglect and abandonment of urban and rural business environment;
2. Listing on the absence of basic resources that suburban entrepreneurs take for granted;
3. How government can reverse neighborhood decline by providing coordinated government resources that will encourage a reexamination of the communities by bankers.

II. Defining the Problem: The mismatch between credit availability and need

A. Data on mortgage availability
1. Description of the federal involvement in mortgage credit;
2. Data on the beneficiaries of the current federally led mortgage credit system;
1. The Federal Reserve study in Boston on mortgage lending discrepancies;
2. The <u>Atlanta Constitution</u> study on "The Color of Money" which showed that upper income blacks had a higher mortgage rejection rate than lower income whites.

B. Data on small business discrimination
1. Discussion on the difficulty of finding data on small business lending;
2. A call for HMDA like disclosure of small business lending -- that is, disclosure by census tract on small business lending;
3. Anecdotal studies on the need for federal involvement in small business lending in urban and rural communities.

III. The Need for Technical Assistance

A. Discussion from existing community development banks on the need for technical assistance
1. Reduction in failure rate;
2. Guidance to the banks and to the customers;

B. Commerce Programs available for technical assistance;
1. one-on-one counselling, with businesses trying to start CDFIs and training programs on managing CDFIs through the Minority Business Development MEGA Centers;
2. one-on-one counselling with business trying to start

revolving loan funds through the Economic Development Administration;

3. one-on-one counselling for businesses seeking to involve themselves in international trade through the International Trade Administration;

4. clearinghouse mechanisms on CDBs and other urban financing programs in databases provided by the National Technical Information Service (NTIS);

5. assisting distressed communities, especially those in the mist of defense conversion through the Economic Development Administration;

6. assisting new entrepreneurs funded by the banks through manufacturing technology centers which allow small and mid-sized manufacturers to learn advanced technology techniques into their operations through NTIS;

7. assist businesses apply technology developed at federal laboratories to their enterprises through NTIS;

C. HUD Technical Assistance programs

1. Non-profit capacity building programs in economic development though the Community Development Block Grant Program;

2. Capacity building for entitlement communities to form public-private partnerships for economic development;

3. Grants to local communities in distressed areas to provide assistance in locating capital sources and coordinating access to capital for self-employment skills for low-income residents;

4. Capacity building of Community Housing Development Organizations to participate in the HOME program of housing assistance;

D. Treasury Technical Assistance efforts

(To be supplied)

of branches, the bank's policies toward branch closings, the hours of operation, and other factors affecting access to banking services. Based on these considerations, the examiner could adjust the initial rating by no more than 2 points. (This is related to current Factor G.)

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- *Enhanced leadership*—The leadership of the regulating agencies would emphasize, through directives and actions, the importance of CRA compliance. The President may use his bully pulpit to reinforce this message.

- *Enhanced penalties authority*—As discussed above, the regulators would establish a schedule of civil money penalties for CRA noncompliance.

B. *Assessment and Comments*

This option reflects the observation that "we've never seen what CRA enforcement under a Democratic administration would look like." This option would likely be easier to implement than Option 1, but its efficacy is less certain. Moreover, the option does not address either bank or community group concerns concerning CD banking.

To: President's Working Group on Community Lending

From: The Nature and Scope Sub-Task Force

Re: The Nature and Scope of the Community Lending Problem

Introduction

The Subcommittee is charged with providing rhetoric and data on the nature, scope and definition of the credit problem faced by lower income Americans particularly those living in central cities and rural areas. The group is currently trying to amass statistical data on the credit problem. Below please find an annotated outline which describes why the CDFI concept is necessary; what is the nature of the credit problem for lower income communities; and why the solution should include capital access and technical assistance.

Discussion

I. Why Community Banks

A. Market failure

1. Definition of the need for access to credit

a. 20 million American households have no relationship with a bank;

b. 60% increase in pawnshops;

c. explosion of expensive check cashing businesses;

d. working capital for urban entrepreneurs generally found in factors that charge significant premiums.

2. Government policies encouraged the decline of the communities

a. FHA policies

b. Enforcement of CRA

3. Job seekers live in these communities with few job opportunities;

a. statistics on number of applicants for limited number of new business start-ups in working class and poor communities;

b. statistics on reverse commuting for entry level jobs in suburbia by urban and rural families;

c. number of urban and rural residents enrolled in Job Corps and JPTA.

B. Racial Discrimination

1. Historical relationship of Banks and minority communities

2. Data on business formation and mortgage lending in minority communities

3. Redlining and other formal and informal lending

policies towards minority communities.

C. Government assistance to the low income;
1. New age Democratic policies to work with business to deliver assistance to low income communities;
2. Goal is to provide the poor with a ladder toward self-determination;
3. In a time of scarce resources, less expensive way to provide assistance;
4. Provides a tool that enables empowerment.

D. Government created obstacles for business formation and mortgage lending;
1. How government neglect and abandonment of urban and rural business environment;
2. Listing on the absence of basic resources that suburban entrepreneurs take for granted;
3. How government can reverse neighborhood decline by providing coordinated government resources that will encourage a reexamination of the communities by bankers.

II. Defining the Problem: The mismatch between credit availability and need
A. Data on mortgage availability
1. Description of the federal involvement in mortgage credit;
2. Data on the beneficiaries of the current federally led mortgage credit system;
1. The Federal Reserve study in Boston on mortgage lending discrepancies;
2. The Atlanta Constitution study on "The Color of Money" which showed that upper income blacks had a higher mortgage rejection rate than lower income whites.

B. Data on small business discrimination
1. Discussion on the difficulty of finding data on small business lending;
2. A call for HMDA like disclosure of small business lending -- that is, disclosure by census tract on small business lending;
3. Anecdotal studies on the need for federal involvement in small business lending in urban and rural communities.

III. The Need for Technical Assistance
A. Discussion from existing community development banks on the need for technical assistance
1. Reduction in failure rate;
2. Guidance to the banks and to the customers;

B. Commerce Programs available for technical assistance;
1. one-on-one counselling, with businesses trying to start CDFIs and training programs on managing CDFIs through the Minority Business Development MEGA Centers;
2. one-on-one counselling with business trying to start

revolving loan funds through the Economic Development Administration;
3. one-on-one counselling for businesses seeking to involve themselves in international trade through the International Trade Administration;
4. clearinghouse mechanisms on CDBs and other urban financing programs in databases provided by the National Technical Information Service (NTIS);
5. assisting distressed communities, especially those in the mist of defense conversion through the Economic Development Administration;
6. assisting new entrepreneurs funded by the banks through manufacturing technology centers which allow small and mid-sized manufacturers to learn advanced technology techniques into their operations through NTIS;
7. assist businesses apply technology developed at federal laboratories to their enterprises through NTIS;

C. HUD Technical Assistance programs
1. Non-profit capacity building programs in economic development though the Community Development Block Grant Program;
2. Capacity building for entitlement communities to form public-private partnerships for economic development;
3. Grants to local communities in distressed areas to provide assistance in locating capital sources and coordinating access to capital for self-employment skills for low-income residents;
4. Capacity building of Community Housing Development Organizations to participate in the HOME program of housing assistance;

D. Treasury Technical Assistance efforts
(To be supplied)

5. Is it sound to focus on only one type of lending per bank in regard to the "lending practices" factor?

6. How will this evaluation system work for rural banks?

7. How should one measure lending in the "lending practices" factor? By dollars extended per person? (This would seem inappropriate as poor areas have lower credit needs.)

8. What is the current level of bank investment in or lending to CD financial institutions? (Such information would help set the rating thresholds for Factor 2.)

9. How should boutique banks be treated in a revised CRA regime?

10. How should wholesale banking specialists be treated in a revised CRA regime?

OPTION 2: ENHANCING CRA ENFORCEMENT PRACTICES

A. *Proposed Enhancements*

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(To be supplied)

DRAFT

File: CD Banks

MEMO TO: CDB Working Group

FROM: David Lebryk
Brian Mathis
Mark Bender

SUBJECT: Discussion of Major Issues Pertaining to Interstate Branching

This memo responds to the Working Group's request for an analysis of the major issues that are raised by both proponents and opponents of interstate branching. The need for this review is driven by the proposal that large bank holding companies (BHCs) would be required to establish subsidiary community development banks (CDBs) in return for which certain interstate branching rights would be provided.

The BHC Subsidiary Proposal

Specifically, the BHC option would require the larger BHCs to allocate some dollar amount to the establishment of subsidiary CDBs.[1] In return these BHCs would receive the right to branch interstate in states where: (1) statewide branching is permitted; (2) nonresident BHCs are currently operating, or would be permitted to operate, a banking subsidiary; and (3) the BHC holds a "sufficient amount" of "qualifying assets" which demonstrate a meaningful and quantifiable commitment to community development in distressed areas of the potential host state.[2] In short, the BHC must first demonstrate satisfactory CDB performance in a selected state, after which the parent could branch into that state if statewide branching were permitted <u>and</u> the BHC is or would be able to operate a subsidiary bank in that state.[3]

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[1] By way of example, the 50 largest BHCs could be required to make, and maintain, an equity investment of 3/4 of 1% of their total equity capital for the establishment of CDBs. This would provide about $1 billion in equity for new CDBs. If assets were leveraged at a conservative 10 times equity, these new CDBs would amount to $10 billion in asset size to start.

[2] The terms "sufficient amount" and "qualifying assets" would be subject to definition and determination in the enabling legislation.

[3] FRB data suggest that only two states (Hawaii and Montana) currently prohibit any form of interstate banking, while only four states (Arkansas, Illinois, Iowa, and Minnesota) still effectively prohibit statewide branching. At this point in time

The BHC option might also provide certain rights directly to adequately-capitalized subsidiary CDBs. First would be the authority for adequately-capitalized CDBs located in distressed areas to invest in, deal in, or underwrite securities issued by small businesses located there, and to sell insurance in these distressed areas. Second would be the authority for adequately-capitalized and satisfactorily performing CDBs to themselves branch nationwide only into other economically distressed areas. The securities and insurance provisions would ensure the availability of "mainstream" financial services critically needed by businesses and residents of distressed areas; at the same time they would buttress safety and soundness by diversifying the risk and stabilizing the earnings of CDBs.[4] The branching provision would ensure that successful CDBs are able to export their expertise to other economically distressed areas; the CDBs would benefit from geographic diversification of risk, while distressed communities would benefit from additional skilled lenders.[5]

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these six states could not accommodate interstate branching for parent BHCs as suggested here.

[4] The securities underwriting provision should be seen as an important adjunct to the existing special authority of national banks, member banks, and BHCs to invest up to 10 percent of unimpaired capital and surplus in equity and debt of Community Development Corporations (CDCs) and Community Development Projects (CDPs). The securities proposal would permit a similar, targeted-area support of small businesses. In a similar manner, the insurance sales provision merely extends to the CDB authority to do what national banks in towns of 5,000 or less, mutual savings banks wherever located, and a large number of state banks already have authority to do (e.g., 17 states currently allow their state banks to brokerage insurance; 5 of these states additionally allow insurance underwriting). CDBs would focus insurance sales in distressed areas where the service is desperately needed.

[5] All of these provisions are made within context of the goals of the community revitalization program and are not unique to this proposal. For example, in recent Congressional testimony a representative of Shorebank Corporation stated that:

> Legislative action defines the permissible activities of these regulated institutions. These permitted activities could be orchestrated to better serve public purposes by allowing those depositories which are most responsive to public needs to also engage in other profit making activities that are now prohibited or curtailed. Interstate banking privileges, authorization to sell insurance, permission to underwrite securities, higher levels of deposit insurance, or other incentives ... could be provided

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As requested by the Working Group, the remainder of this memo will examine the major arguments offered by the proponents and opponents of interstate branching.

Arguments in Favor of Interstate Branching

<u>Eroding Effectiveness of Geographic Restrictions</u>

Proponents of interstate branching argue that it is difficult to determine exactly what economic purpose is now served by restrictions on geographic diversification of bank offices. For one thing, banking organizations today simply cannot be defined in terms of the limited services and facilities appropriate to the McFadden era.[6] For another, there currently exist a wide range of non-bank institutions that offer close substitutes for bank products and operate unencumbered by geographic restrictions. On both sides of the balance sheet, the business of banking has now gone far beyond the restricted range of services underpinning McFadden.

On the liability side, banking organizations now fund themselves not only with local retail deposits, but with large negotiated certificates of deposit, brokered deposits, Eurodollar borrowings, foreign deposits, and debt issues. These funding sources can involve local, regional, national, and international financial markets. On the asset side also, banks long ago reached beyond strictly local markets for business and consumer loans. Real estate loans, commercial loans, foreign government loans, securitization of loan assets, and various types of loan participations typically require involvement in non-local markets. This is also true of other services such as cash management, electronic funds transfers, private placements, credit card distributions, and certain off-balance sheet activities.

> to banks engaged in public purpose lending. Such privileges, however, should only be granted to banks that meet a high hurdle of investment in low and moderate income communities.

See, statement of Robert M. Weissbourd, Vice President, Shorebank Corporation, before the House Subcommittee on Consumer Credit and Insurance, January 27, 1993, pg. 7.

[6] Section 7(f) of McFadden defined a "branch" to include "any branch office, branch agency, additional office, or any branch place of business located in any State or Territory of the United States or in the District of Columbia at which deposits are received, or checks paid, or money lent."

Even with respect to brick-and-mortar facilities, geographic restrictions have proven to be quite porous. For example, the loan production offices (LPOs) and Edge Corporations of banks are not limited by "home state" geographic restrictions. And bank holding companies have routinely offered financial services such as mortgage finance, consumer finance, and discount brokerage across state boundaries through subsidiaries. Also, certain interstate banking activities of bank holding companies and foreign banks were grandfathered in the Bank Holding Company Act of 1956 and the International Banking Act of 1978. Finally, bank holding companies were especially effective in the 1970s and 1980s at using networks of nonbank banks and acquired thrift institutions to establish interstate networks of limited and full service banking operations. In this respect it has been reported that "By year end 1988, ... 14,600 interstate offices of banking organizations were in operation, of which 7,500 could offer a full line of banking services and about 7,100 could offer limited banking services."[7]

<u>Non-Bank Institutions</u>. A significant number of non-bank financial institutions offer products that compete directly with bank services, yet these non-banks have never been forced into the inefficiencies that accompany geographic restrictions. Securities firms effectively compete for the funds of savers by offering insured brokered CDs as well as cash management accounts with check-writing and credit card features through large networks of geographically dispersed offices. Also, insurance companies provide a bank-like savings service. In effect, when the holder of a whole-life policy pays premiums a portion of each payment accumulates and earns interest as does a savings account. The policyholder is free to surrender the policy and "withdraw" its cash value. Or, a policyholder may borrow against the "loan value" of the policy at a modest interest rate and without obligation to repay: the policy loans of life insurance companies amounted to $57.4 billion at year-end 1989.[8] In these respects life insurers offer a service not unlike bank passbook savings accounts. In addition, it should be remembered that securities firms and insurance companies were major acquirors of "non-bank banks" until the passage of restrictive legislation in 1987.

Other major bank competitors that operate free of branching restrictions include consumer, business, and sales finance companies, mortgage companies, thrift institutions, the "captive finance" firms of automobile and appliance manufacturers, and retail credit grantors, among others.

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[7] Rose, Peter S., <u>The Interstate Banking Revolution</u>, Quorum Books, New York, 1989, pg. 13.

[8] American Council of Life Insurance, <u>1990 Life Insurance Fact Book</u>, Washington, D.C., 1990, pg. 100.

<u>Explanatory Factors</u>. A number of factors help to explain the 1980s' trend towards fewer geographic restrictions on banks, most notably the adoption of interstate banking. The desire to attract and pool capital that could be used to support a state's economic growth and development was perhaps the major motivation for both statewide branching and interstate banking provisions. This appears to have been the case for states such as Maine, Delaware, South Dakota, and the states of the Southwest (such as Louisiana, Texas, and Oklahoma).[10]

Another major factor was the need to facilitate the resolution of troubled banks and thrifts by permitting acquisitions by institutions from outside of the state (provisions for which were contained in the Garn-St Germain Act of 1982).[11] For example, the majority of bank failures of the past years occurred in the Southwestern states of Arkansas, Louisiana, New Mexico, Oklahoma, and Texas. Since 1980, Texas and Oklahoma effectively shifted from unit banking to statewide branching. In addition, all of the Southwestern states except Arkansas now permit nationwide interstate banking; Arkansas permits interstate banking based on regional reciprocity. The importance of these changes in geographic restrictions for a state such as Texas was obvious from the Chemical Bank/Texas Commerce and NCNB/First RepublicBank transactions.

A third major factor explaining liberalization of geographic restrictions was the growing pressure exerted by the banking industry on state regulators to establish a "level playing field" for banks vis-a-vis their nonbank competitors.[12] As discussed above, numerous nonbank institutions compete with banks over a wide range of financial services without any geographic restrictions to contend with. More and more states have come to understand that artificially imposed geographic restrictions can only erode the competitive viability of the commercial banks their own economic vitality depends upon.

<u>Safety and Soundness</u>

All other considerations notwithstanding, a strong case

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in earnest.

[10] Rose, op. cit., pp. 25-28. Specifically, according to Rose, "..the desire to improve local economies and to stimulate local and regional economic development stands at the top of the list of causal factors behind interstate banking."

[11] Ibid., pp. 29-30.

[12] Ibid., pp. 30-31.

generally can be made for any structural arrangement that enhances safety and soundness (or reduces risk) in the banking system because of the public's exposure to the costs of bank failures. The degree of risk of an activity is measured by the variability of the cash flow, revenue, or rate of return of that activity; to the extent this variability is suppressed, risk is reduced. In the case of commercial banking, diversification traditionally has been viewed as one of the most important elements of risk control (as opposed to deposit insurance which is fundamentally a mechanism for shifting risk from the institution and its depositors to the insurance fund).

In recent years, many of the proposals for financial institutions restructuring have relied in large part on the potential risk reduction benefits of diversification. For example, proponents of securities activities for commercial banks argue that there is a low correlation between the revenue flows from commercial loans and from securities underwriting activities, meaning that the variability of the combined flow of income from these activities would be less than that of either activity taken alone. This leads to the conclusion that permitting commercial banks to engage in full service securities activities would reduce overall risk (enhance safety and soundness) in the banking system.[13]

The diversification argument for expanded activities is easily transferred to the question of geographic location. In short, the earnings of commercial banks limited in geographic reach may be extremely susceptible to the vagaries of local market cycles due to the lack of diversification of traditional assets. Moreover, this risk will itself tend to vary inversely with the degree of diversification of the local market, or state economy. Proponents of interstate banking and branching argue that relaxing bank geographic restrictions will yield a combined income flow from different regions that is more stable than that

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[13] See, Rethinking Glass-Steagall, J.P. Morgan & Co. Incorporated, pp. 20-22. Specifically,

> Not only is the securities business more profitable than the banking business, but commercial bank entry into corporate securities activities would also allow banks to diversify their sources of revenue and reduce earnings volatility. ...for example, corporate bond issuance and the growth of bank commercial and industrial loans are negatively correlated. When corporate bond issuance is high, the demand for bank loans is low; when bank loan demand is high, bond sales tend to drop off. Thus involvement in the corporate securities business might well prove beneficial in enabling bank holding companies to even out swings in earnings associated with changes in loan demand. (pg. 12)

of each region individually. In this regard, a recent statistical study concluded that "a majority of states with failure rates above the national average are characterized by economies that are generally not well diversified;" and "the inability of banks to diversify their loan portfolios is partly responsible for the reported higher than average rate of bank failures in some states."[14]

Other empirical studies uniformly find that branch banks have historically had a better safety record than unit banks, which have no branches. An examination of the record of bank failures and the consequent behavior of the states in recent years confirms this. For example, during the 1970s, Texas banks were confined by state laws to a single full-service location, but were considered among the best-capitalized, most profitable banks in America. Ten years later, after severe problems with the energy economy, nine of the top ten had been reorganized with FDIC or other outside assistance. Appropriate regional diversification might have prevented some of these failures. As noted earlier, Texas has since adopted both statewide branching and nationwide banking.

Competition and Performance

Restrictions on branching, be they intrastate or interstate, represent barriers to market entry that may permit protected institutions to perform at less than competitive standards. Evidence of this could include higher profits, lower loan output, higher prices for financial services and products, reduced convenience for consumers, and lower interest rates paid on deposits, among others.

A large number of studies of the impact of branch banking on market structure and performance have been done over the years. For the most part these studies have found that ease of entry through branching improves performance; and, in particular, little or no evidence is found to support the arguments that branch banking will lead to a decline in the number of community banks and divert credit from local borrowers.

A comprehensive 1981 study of branching issues specifically examined the question of the impact of branching on banking markets in local communities.[15] After an examination of the evidence based on statewide branching, limited branching, and

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[14] Hawawini, Gabriel and Itzhak Swary, Mergers and Acquisitions in the U.S. Banking Industry: Evidence from the Capital Markets, North Holland, New York, 1990, pg. 62.

[15] U.S. Treasury Department, Geographic Restrictions on Commercial Banking in the United States, January 1981, Chapter 6.

unit banking states, it was concluded that broader branching authority brought with it "noticeable benefits" to local communities. These benefits took the form of greater consumer convenience through the availability of more bank offices and enhanced bank performance. In particular, broader branching authority was found to "result in increased potential competition and lower prices and other more liberal terms for bank loan services, higher deposit interest rates, greater loan output, and lower profits." Moreover, no evidence was found of either a restriction of credit to local borrowers or a decrease in the number of banking alternatives in local communities.

A more recent survey of the evidence on branching confirms most of the findings discussed above.[16] Of special interest is the fact that when commercial banks were grouped by size and branching status, using 1984 data, a consistent pattern emerged showing that (1) the loan-to-asset ratios of larger banks exceeded those of smaller banks, and (2) for all size categories, banks in statewide branching states had higher loan-to-asset ratios than their peer groups for the United States overall. Also, in an assessment of consumer convenience, measured by population per banking office, it was found that "unit banking states tend to service more persons per banking office than either limited or statewide branching states, indicating a relative lack of consumer convenience in unit banking states." Finally, branching was found to be a significant factor in promoting "more efficient" pricing of bank services.

Interstate branching can create additional unique conveniences for consumers, particularly those who frequently cross state lines for work or other reasons. Today, a customer with a bank account in one state typically cannot get full-service banking services from an affiliated bank in another state without opening a separate account; there would be no such problem with interstate branching. An interstate branching network would also make cash and banking services available to travelers.

Efficiency and Cost Savings

Briefly put, a financial intermediary is a mechanism for the collection and distribution (allocation) of funds. Banks (or other insured depositories) typically collect the greatest part

[16] Scheld, Karl A. and Baer, Herbert, "Interstate Banking and Intrastate Branching: Summing Up," Toward Nationwide Banking: A Guide to the Issues, Federal Reserve Bank of Chicago, 1986, pp. 75-83.

of their funds from insured and uninsured depositors; the remainder comes from other creditors/debtholders and equity investors. In turn these funds are allocated to commercial, consumer, or housing loans (the mix depending upon the relative specialization of the institution). The expenses of the bank are twofold in nature: First, the cost of collected funds which is largely determined by market interest rates (and is known as interest expense IE). Second, all of the ancillary costs of operating the bank including employees, information processing, transactions costs, maintenance of brick and mortar facilities, management and administration, regulatory compliance, legal and advertising costs, and so on (all of which are known as noninterest expense NIE).

Cost savings from commercial bank branching are generally estimated at two different levels of aggregation. In the first case, nationwide branching is viewed as facilitating the consolidation of the overall banking system through mergers and acquisitions. It is argued that if overall consolidation is characterized by efficient firms acquiring inefficient firms substantial reductions in NIE can be realized for the entire banking system. In the second case, a reduced level of interstate branching would be designed to allow multibank firms operating in several states to consolidate their subsidiary banks into a branch banking system. The nature of the cost savings would be identical to that of nationwide branching, but the overall magnitude of those savings clearly would be less.

Estimated Consolidation Savings. Analysis offered by McKinsey & Company strongly supports the notion of cost savings through bank consolidation.[17] It is argued that the combined noninterest expenses (NIE) of merged institutions can be reduced by 20 to 25 percent of premerger levels, "half of the saving comes from the salaries and benefits of redundant employees; the remainder comes from closing [redundant] branches and reducing the cost of rent, office equipment, systems, marketing and professional services." According to this analysis, tremendous excess capacity in the banking industry nationwide, manifested in large ($120 billion) and growing (10 percent per year) NIE, is at the heart of the problem. Elimination of this excess capacity suggests that NIE "could easily fall by $10 billion to $15 billion." Finally, this analysis holds that total industry savings of $15 billion per year "could add more than $45 billion

[17] Mendoca, Larry, "Done Right, Bank Mergers Can Save Money," Wall Street Journal, May 13, 1992. (The McKinsey findings essentially represent an extrapolation of observations made on a few large institutions to the overall banking industry.)

to the industry's market value."[18] If a reduced level of branching is considered, that is, interstate branching for the multibank holding companies now operating interstate, McKinsey estimates total annual cost savings ranging from a low of $416 million to a high of $813 million (with a midpoint of $624 million).

A recent academic study of the branching/consolidation issue provides conceptual and analytical support to the McKinsey analysis.[19] This study finds evidence of a substantial dispersion in bank costs in all bank size categories. In fact, after grouping banks in four cost quartiles, it was found that "the highest cost quartile of banks have average costs that are 23% higher than those of the lowest quartile," a difference largely accounted for by variations in efficiency. It follows

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[18] In a separate publication, another McKinsey representative has made the case with respect to noninterest expenses as follows:

> Whenever we at McKinsey have analyzed non-interest expenses in an individual bank, we have seen that the links to revenues are tenuous indeed. Typically, we find that some 20 percent to 30 percent of expenses are for pure overhead and control functions (that is, expenses that contribute neither to attracting nor serving customers -- such as finance or personnel departments, auditors, and the like). Another 20 percent to 25 percent are for shared distribution expenses -- in particular, branches. Another 20 percent to 30 percent are for shared operating expenses. Only the remaining 15 percent to 20 percent can be attributed to bringing in specific customers and actually delivering services. (pg. 44)

> Furthermore:

> ... our analysis of a broad cross section of the industry has shown that large regional banks can operate at significantly lower costs than a smaller regional with the same customer mix. For example, we estimate a $20-billion regional bank might have operating costs as a percentage of assets of 2.5 percent to 3.0 percent, whereas a $3- to $4-billion regional bank might have operating costs as a percentage of assets of 3.5 percent to 4.0 percent. (pg. 85)

See, Bryan, Lowell L., Bankrupt: Restoring the Health and Profitability of Our Banking System, Harper Business, 1991.

[19] Humphrey, David Burras, "The Likely Effects of Interstate Branching on Bank Costs and Service Prices," Prepared for the Congressional Budget Office, October 1991.

that to the extent interstate branching fosters the absorption of inefficient banks by efficient banks, total banking system costs might be reduced. The overall magnitude of cost savings was estimated to be around 3% to 4%, depending upon the degree to which the performance of inefficient banks could be made to match the overall mean or the second lowest quartile of banks, respectively. (These results were found to be reasonably compatible with McKinsey's implied 3% to 6% savings in total systemwide banking industry costs).

Even the Conference of State Bank Supervisors (CSBS), in an effort to diminish the importance of cost savings through branching, estimated that annual savings through branching might amount to "only" $2 billion. But this is not a meaningless sum of money -- over ten years it would amount to $20 billion, a good portion of which would show up in strengthened capital for banks.

Arguments in Opposition to Interstate Branching

Consolidation of Small Banks

One of the most frequently heard arguments against interstate branching is that it will inevitably lead to a decline in the number of small banks. The premise of this argument is that permitting the entry of large institutions into local, protected markets will result in the "driving out" or "buying out" of small community banks. However, there is ample evidence that this is not an inevitable outcome. For example, in states where branching restrictions were significantly relaxed in recent years, such as New York, small banks have continued to prosper. And when Maine opened itself up for interstate banking, Citicorp established a *de novo* bank in Portland in 1984. By mid-1989, Citicorp/Maine had captured less than 3 percent of total commercial bank, savings bank, and savings and loan association deposits. Overall, fears about the viability of small banks and the maintenance of competition in the face of relaxed geographic restrictions do not appear to have an empirical base.

Furthermore, even in states that have long had liberal branching laws, small banks more than hold their own. For example, both North and South Carolina have statewide branching laws of long standing. Nevertheless, in 1991, in North Carolina 68 out of a total of 78 banks had assets of less than $500 million; in South Carolina 78 out of a total of 84 banks had assets of less than $500 million.

The vast majority of small banks are actually among the most profitable and best-capitalized banks in the nation. These financially strong banks are quite capable of continued survival in the face of nationwide banking and branching, provided their owners are committed to maintaining their independence. On balance, it may be true that interstate branching will assist in the needed consolidation of weak banks of whatever size; but it will not mean the automatic consolidation of well-capitalized and well-managed small banks.

End of Dual Banking System

It is also claimed by opponents of interstate banking and branching proposals that such measures would damage the dual banking system beyond repair. For one thing, it is said that the states would be effectively "stripped" of their ability to impose terms and conditions on the operations of banks within their borders. But this is just not the case. All of the major legislative proposals of recent years deferred to the states in a large number of important ways. Most importantly, states retained the right to govern intrastate branching, for both national and state banks; and they retained their control over the interstate branching privileges of their own state banks. In addition, most proposals granted "host states" the right to limit the activities of the branches of out-of-state banks, national banks excepted, to no more than the activities allowed their own in-state banks. Moreover, interstate branching proposals typically yielded to the states on the issue of requiring national bank compliance with local state laws regarding fair lending practices, state capital requirements, unsafe and unsound banking practices, community reinvestment requirements, and state taxation.[20]

No Local Reinvestment

Another argument often made by opponents of interstate branching is that it will undermine the intent of the Community Reinvestment Act of 1977 (CRA) and lead to a "siphoning off" of funds from local markets. But there is simply no firm evidence that branch banks are more inclined than other banking organizations to "siphon off" funds from local communities. To the contrary, numerous studies over the past decade suggest that bank expansion can result in a greater proportion of loans to local customers than where bank expansion is limited. Typically, banks have higher loan-to-asset ratios -- that is, employ a greater proportion of their resources for loans -- when they

[20] There does not appear to be any authority that would accord states a lesser right to tax in-state activities of a national or state bank that has its home office in another state. In particular, section 548 of Title 12 of the U.S. Code, which addresses state taxation of national banks, does not indicate that national banks are to be treated differently than other corporations in this respect.

operate in broader branching states than in restricted branching states.

Furthermore, it must be recognized that the "siphoning off" of funds is really not unique to branch banking. For example, a bank not wishing to lend in its local area could sell federal funds upstream to a correspondent bank, partake in loan participations, or put its funds into investment securities rather than loans.

Finally, the argument that branches suck credit out of a region is a two-edged sword: The ability to draw credit out of an area implies the ability to inject credit into an area, so branches are as likely to bring funds into local communities as to take funds out (which was one of the major reasons for states moving to liberal branching laws).

Concentration of Resources

A long-standing concern with respect to the removal of geographic restrictions involves the potential impact on the concentration of banking resources. Critical to any assessment of concentration, however, is the definition of market used. Results will typically vary depending upon whether the market is defined as local (SMSAs), regional, statewide, or national. The competitive implications of most bank mergers in the U.S. are still evaluated in terms of their potential impact on local markets, both urban and rural. Local concentration is typically measured by three-firm concentration ratios, i.e., the share of total bank assets or deposits in a given local area (normally a Metropolitan Statistical Area, MSA) held by the top three firms. In this respect, the data show that concentration in local urban and rural markets remained virtually unchanged between 1976 and 1991. In spite of the fact that concentration at the relevant local market level remains far from worrisome, a number of states have enacted deposit concentration limits.[21] It is important to note that the BHC subsidiary option would not override state concentration limits.

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[21] Although concentration at the local market level remains largely unchanged for many years now, sixteen states have nevertheless implemented caps on deposit share (Arkansas, Colorado, Iowa, Kansas, Kentucky, Massachusetts, Missouri, Mississippi, North Dakota, Nevada, Ohio, Oklahoma, New Hampshire, Tennessee, Texas, and West Virginia). These caps range from a low of 10 percent to a high of 25 percent; and the caps vary from including commercial bank deposits only to including the deposits of all depository institutions. And Senator Dodd's "Interstate Banking and Branching Act of 1993" (S. 371) includes both nationwide (no more than 10 percent) and statewide (30 percent or more) asset caps.

Moreover, banks compete with other insured depositories and non-depository financial intermediaries across a broad range of activities, and these other bank competitors are not represented in simple ratios on concentration of bank assets or deposits. Indeed, in recent years the federal bank regulators and the antitrust enforcement agencies have been attempting to redefine relevant product and geographic markets to better accommodate the competitive impact of non-regulated financial services providers.

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Summary of State Bank Expansion Laws (1992)

Intrastate Branching

- 47 states (including District of Columbia) currently have laws permitting statewide branching.
- 4 states have laws that permit limited (county or parish) branching (AK, IL, IA, MN).

Interstate Banking

- 12 states have enacted national non-reciprocal interstate banking laws (AK, AZ, CO, ID, ME, NV, NM, OK, OR, TX, UT, WY).
- 22 states have enacted national reciprocal interstate banking laws (CA, CT, DE, IL, IN, KY, LA, MA, MI, NE, NH, NJ, NY, ND, OH, PA, RI, TN, SD, VT, WA, WV).
- 15 states (including District of Columbia) have enacted regional reciprocal interstate banking laws (AL, AR, DC, FL, GA, IA, KS, MD, MN, MS, MO, NC, SC, VA, WI).
- 2 states continue to prohibit interstate banking (Hawaii and Montana).

Interstate Branching

- As a general matter, no state currently permits interstate branching.

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INTERSTATE BANKING LEGISLATION BY STATE
(AS OF JANUARY 1, [illegible])

STATE	LEGISLATION IN EFFECT	AREA
Alabama	Currently	Reciprocal. 13 States and DC (AR. FL. GA. KY. LA. MD. MS. NC. SC. TN. TX. VA. WV. DC)
Alaska	Currently	National, no reciprocity.
Arizona	Currently	National, no reciprocity.
Arkansas	Currently	Reciprocal. 16 States and DC (AL. FL. GA. KS. LA. MD. MO. MS. NC. NE. OK. SC. TN. TX. VA. WV. DC)
California	Currently	National, reciprocal.
Colorado	Currently	National, no reciprocity.
Connecticut	Currently	National, reciprocal
Delaware	Currently	National, reciprocal
District of Columbia	Currently	Reciprocal. 11 States (AL. FL. GA. LA. MD. MS. NC. SC. TN. VA. WV)
Florida	Currently	Reciprocal. 11 States and DC (AL. AR. GA. LA. MD. MS. NC. SC. TN. VA. WV. DC)
Georgia	Currently	Reciprocal. 10 States and DC (AL. DC. FL. KY. LA. MD. MS. NC. SC. TN. VA)
Idaho	Currently	National, no reciprocity.
Illinois	Currently	National, reciprocal.
Indiana	Currently	National, reciprocal.
Iowa	Currently	Reciprocal. 6 States (IL. MN. MO. NE. SD. WI)
Kansas	Currently	Reciprocal. 6 States (AR. CO. IA. MO. NE. OK)
Kentucky	Currently	National, reciprocal.
Louisiana	Currently	National, reciprocal.

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STATE	LEGISLATION IN EFFECT	AREA
Maine	Currently	National, no reciprocity.
Maryland	Currently	Reciprocal, 14 States and DC (AL, AR, DE, FL, GA, KY, LA, MS, NC, PA, SC, TN, VA, WV, DC)
Massachusetts	Currently	National, reciprocal.
Michigan	Currently	National, reciprocal.
Minnesota	Currently	Reciprocal, 16 States (CO, IA, ID, IL, IN, KS, MI, MO, MT, ND, NE, OH, SD, WA, WI, WY)
Mississippi	Currently	Reciprocal, 13 States (AL, AR, FL, GA, KY, LA, MO, NC, SC, TN, TX, VA, WV)
Missouri	Currently	Reciprocal, 8 States (AR, IA, IL, KS, KY, NE, OK, TN)
Nebraska	Currently	National, reciprocal.
Nevada	Currently	National, no reciprocity
New Hampshire	Currently	National, no reciprocity
New Jersey	Currently	National, reciprocal.
New Mexico	Currently	National, no reciprocity.
New York	Currently	National, reciprocal.
North Carolina	Currently	Reciprocal, 13 States and DC (AL, AR, FL, GA, KY, LA, MD, MS, SC, TN, TX, VA, WV, DC)
North Dakota	Currently	National, reciprocal.
Ohio	Currently	National, reciprocal.
Oklahoma	Currently	National. After initial entry, BHC must be from state offering reciprocity or wait 4 years to expand.
Oregon	Currently	National, no reciprocity.
Pennsylvania	Currently	National, reciprocal
Rhode Island	Currently	National, reciprocal.

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STATE	LEGISLATION IN EFFECT	AREA
South Carolina	Currently	Reciprocal. 12 States and DC (AL. AR. FL. GA. KY. LA. MD. MS. NC. TN. VA. WV. DC)
South Dakota	Currently	National. reciprocal.
Tennessee	Currently	National. reciprocal.
Texas	Currently	National. no reciprocity.
Utah	Currently	National. no reciprocity.
Vermont	Currently	National. reciprocal
Virginia	Currently	Reciprocal. 12 States and DC (AL. AR. FL. GA. KY. LA. MD. MS. NC. SC. TN. WV. DC)
Washington	Currently	National. reciprocal.
West Virginia	Currently	National. reciprocal.
Wisconsin	Currently	Reciprocal. 8 States (IA. IL. IN. KY. MI. MN. MO. OH)
Wyoming	Currently	National. no reciprocity.

Note: Several states prohibit acquisition of banks in operation for less than a specified number of years.

Source: Financial Structure Section. Board of Governors of the Federal Reserve System.

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BHC Interstate Operations

- Thirty-nine of the top 50 BHCs in terms of assets have interstate banking offices.
- Forty-five states plus the District of Columbia contain banks owned by at least one of those 39 BHCs that have interstate operations.
- Five states contain neither an out-of-state BHC (from the list of 39 BHCs that have interstate operations) nor the home office of any of the top 50 BHCs.
  - -- These states are: Arkansas, Kansas, Louisiana, Mississippi and West Virginia.

March 17, 1993

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S. 371 -- Interstate Banking and Branching Act (Dodd)

Summary of Major Provisions

- Provides for nationwide interstate banking via acquisitions of existing banks by BHCs effective 1 year after enactment; and by establishment of new banks effective 2 years after enactment.

  -- Acquisitions are prohibited if the applicant controls, or upon completion of the acquisition would control, more than 10 percent of insured depository institution assets nationwide; or 30 percent or more of insured depository institution deposits in the state in which the bank to be acquired is located.

- Beginning 18 months after enactment multistate BHCs may consolidate interstate banks into branches (unless prohibited by the host state).

- Beginning 3 years after enactment banks are permitted to branch interstate.

  -- Interstate branches are subject to the laws of the host state with respect to intrastate branching, consumer protection, fair lending, community reinvestment, and nondiscriminatory franchise (or other nonproperty) taxes.

  -- Host states may require all banks using this branching provision to comply with nondiscriminatory filing requirements.

  -- State banks may not conduct any activity at their interstate branches that is not permissible for a bank chartered by the host state.

  -- The concentration limits applicable to BHC acquisitions also are applicable to branch acquisitions.

  -- State banks chartered by, and national banks with their main office in states that do not permit interstate branching may not themselves branch interstate.

- Within 3 years of the date of enactment a state may elect to "opt out" of interstate branching through law that expressly prohibits all out-of-state national and state banks from acquiring or establishing branches in that state. (This election may at any time be reversed by the state.)

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- During the 3-year period following enactment a national bank may establish an interstate branch provided that the prospective host state has specifically enacted legislation permitting the establishment of branches by all out-of-state national and state banks.

- Foreign banks are provided "national treatment" with respect to interstate branching.

- The appropriate federal regulator must make a written evaluation of the entire institution's CRA performance; and again for each state where the institution has a branch.

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H.R. 459 -- Nationwide Banking and Branching Act (Hoagland)

Summary of Major Provisions

- Provides for nationwide interstate banking via subsidiaries by BHCs or foreign banks effective with enactment.

- Beginning two years after enactment banks are permitted to branch interstate (national banks subject to specific consideration of CRA ratings).

    -- Host states may require all banks using this branching provision to comply with nondiscriminatory filing requirements.

    -- State banks may not conduct any activity at their interstate branches that is not permissible for a bank chartered by the host state.

- Within two years of the date of enactment a state may elect to prohibit interstate branching through law that expressly prohibits all out-of-state national and state banks from acquiring or establishing branches in that state. (This election may at any time be reversed by the state.)

    -- State banks chartered by host states that do not pernit interstate branching may not themselves branch interstate.

- During the two-year period following enactment a national bank may establish an interstate branch provided that the prospective host state has specifically enacted legislation permitting the establishment of branches by all out-of-state national and state banks.

- Host state regulatory authorities may examine out-of-state bank branches to determine compliance with host state laws.

- Host state taxation authority is not compromised by interstate branching provisions.

- Multistate BHCs are authorized to combine subsidiary banks into a single bank two years after enactment and subject to the branching restrictions of host states.

    -- States may "opt out" of this consolidation provision.

- Foreign banks are provided "national treatment" with respect to interstate banking and branching.

- The appropriate federal regulator must make a written evaluation of the entire institution's CRA performance; and again for each state where the institution has a branch.

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H.R. 256 -- The Bank Efficiency Act (Neal)

Summary of Major Provisions

- BHCs with banking subsidiaries in more than one state could combine two or more of them into a single bank.
- States can "opt out" of this provision if they specifically enact legislation to do so within two years of enactment of H.R. 256.
- If any bank resulting from the provisions of H.R. 256 ceases to be a subsidiary of a BHC it shall, within two years of termination of its subsidiary status, no longer be entitled to the benefits of this law and must comply with all provisions of state and federal law regarding branching.
- All branches resulting from a combination under H.R. 256 can be retained; and intrastate branching would be subject to state law.
- The host state regulator may independently determine whether an activity of an out-of-state branch of a state bank is permissible. (State authority does not reach to the permissible activities of national banks.)
- A state bank resulting from a combination would only be subject to the examination and supervision of the chartering state. However, the home and host states may enter into a cooperative agreement to facilitate supervision of the bank and its branches.

MARKET SHARE CAPS: A STATE-BY-STATE ROUNDUP

State	Limit on deposit share	Based on deposits at: Banks	Thrifts	Credit unions	Legislative status
Arkansas	25%	•			Recently raised from 15%
Colorado	25	•	■	♦	Passed in 1988. Applies to out-of-state banks only; no change foreseen
Iowa	10	•	■	♦	Bill pending to either raise or eliminate cap
Kansas	12	•			Legislation in progress that would raise cap to 18%
Kentucky	15	•	■	♦	Raised in July 1992 from 15% of bank deposits only
Massachusetts	15	•			Passed in 1990; no change foreseen
Missouri	13	•	■	♦	Informal expansion proposal rejected last year; further proposals expected
Mississippi	19	•	■	♦	Passed in July 1990; no change foreseen
North Dakota	19	•	■	♦	For out-of-state banks only. Passed in 1991; no change foreseen
Nevada	14	•	■		No change foreseen
Ohio	20	•	■		No change foreseen
Oklahoma	11	•	■	♦	Expansion proposal seen as likely
New Hampshire	20	•	■	♦	Raised from 15% in 1990; no change foreseen
Tennessee	16.5	•	■	♦	No change foreseen

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State	Limit on deposit share	Based on deposits at: Banks	Thrifts	Credit unions	Legislative status
Texas	25	•			Passed in 1987; no change foreseen
West Virginia	20	•	■	•	No change foreseen

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Explanatory Factors. A number of factors help to explain the 1980s' trend towards fewer geographic restrictions on banks, most notably the adoption of interstate banking. The desire to attract and pool capital that could be used to support a state's economic growth and development was perhaps the major motivation for both statewide branching and interstate banking provisions. This appears to have been the case for states such as Maine, Delaware, South Dakota, and the states of the Southwest (such as Louisiana, Texas, and Oklahoma).[10]

Another major factor was the need to facilitate the resolution of troubled banks and thrifts by permitting acquisitions by institutions from outside of the state (provisions for which were contained in the Garn-St Germain Act of 1982).[11] For example, the majority of bank failures of the past years occurred in the Southwestern states of Arkansas, Louisiana, New Mexico, Oklahoma, and Texas. Since 1980, Texas and Oklahoma effectively shifted from unit banking to statewide branching. In addition, all of the Southwestern states except Arkansas now permit nationwide interstate banking; Arkansas permits interstate banking based on regional reciprocity. The importance of these changes in geographic restrictions for a state such as Texas was obvious from the Chemical Bank/Texas Commerce and NCNB/First RepublicBank transactions.

A third major factor explaining liberalization of geographic restrictions was the growing pressure exerted by the banking industry on state regulators to establish a "level playing field" for banks vis-a-vis their nonbank competitors.[12] As discussed above, numerous nonbank institutions compete with banks over a wide range of financial services without any geographic restrictions to contend with. More and more states have come to understand that artificially imposed geographic restrictions can only erode the competitive viability of the commercial banks their own economic vitality depends upon.

Safety and Soundness

All other considerations notwithstanding, a strong case

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in earnest.

[10] Rose, op. cit., pp. 25-28. Specifically, according to Rose, "..the desire to improve local economies and to stimulate local and regional economic development stands at the top of the list of causal factors behind interstate banking."

[11] Ibid., pp. 29-30.

[12] Ibid., pp. 30-31.