Banks and nonbanks: A run for the money

Harvey Rosenblum, Diane Siegel, and Christine Pavel

For many years, commercial banks have competed in some product lines with other financial institutions such as S&Ls, mutual savings banks, and credit unions. Recently, commercial banks have increasingly found themselves faced with new competitors—manufacturers such as General Motors Corporation, retailers such as Sears, Roebuck and Company, and diversified financial concerns such as Merrill Lynch and American Express. This new mixed breed of nonbank financial companies and even nonfinancial companies has been encroaching on banks' "turf" over the last decade. And banks, though constrained by regulations, have not willingly shared their traditional business of lending and deposit-taking; rather, they have sought footholds in some of their new competitors' markets.

This article examines the expanded competition in the financial services industry first by quantifying the extent and impact of competition against depository institutions, especially commercial banks, by nonbank companies and then by looking at what depository institutions have done to meet their new competition.

Nonbank Competition—An Historical Overview

Two decades ago the only significant nonfinancial-based firms dealing in financial services were Sears and General Motors with 1962 respective net incomes from financial services of $50.4 million and $40.9 million.[1]

But nonfinancial-based companies have taken a major competitive position in financial services in the past ten years. Such companies have been offering credit and other financial services not as loss leaders to attract additional business, but as profit-making products.[2]

A sample of ten nonfinancial-based companies with impressive earnings from financial services in 1972 is presented in Table 1. During 1972, these companies had net profits from financial activities that totaled $662.2 million. By year-end 1981, their earnings from financial services had reached $1.7 billion, more than 2½ times the 1972 total and certainly more than can be accounted for by inflation. Only two of these companies had lower percentages of earnings attributable to financial services in 1981 than in 1972. The others had higher percentages; in fact, were it not for its finance subsidiary, General Motors would have posted a net loss in 1981.

General Motors and Sears, with 1981 earnings from financial activities of $365 million and $385 million respectively, each had approximately the same financial service earnings as J. P. Morgan & Co., the holding company for the nation's fifth largest bank. Among the nation's largest banking firms, only Citicorp, BankAmerica Corporation, and Chase Manhattan Corporation had earnings that exceeded the financial service earnings of these nonbank giants.

Many of the manufacturers listed in Table 1 originally financed only their own products and therefore did not effectively compete with commercial banks. But by 1972, many of these so-called "captive" finance companies were engaged in financial activities unrelated to the sale of their parents' products.

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[1]Cleveland A. Christophe, *Competition in Financial Services*, New York: First National City Corporation, 1974.

In this study of eleven companies, Christophe provides an in-depth view of the relative importance of banks and nonfinancial firms in the extension of consumer credit. Rosenblum and Siegel, *Competition in Financial Services: The Impact of Non-bank Entry* Staff Study 83-1 from which this article is adapted, updates Christophe's work and elaborates upon new competition in other segments of the banking business such as business credit and retail deposits.

[2]As pointed out in "Banking's New Competition: Myths and Realities," *Economic Review*, Federal Reserve Bank of Atlanta, January 1982, pp. 4-11, by William F. Ford, many nonbank firms have sought to enter the product lines of commercial banks because banking appears to be more profitable relative to their traditional lines of business. Yet, despite the entry of these nonbank firms, commercial banks have remained more profitable than their new competitors.

Table 1

Financial service earnings of nonfinancial-based companies (estimated)

	1972		1981	
	Million dollars	Percent of total earnings	Million dollars	Percent of total earnings
Borg-Warner	$6.3	10.6%	$31	18.0%
Control Data	55.6	96.2	50	29.2
Ford Motor	44.1	5.1	186	n.a.[1]
General Electric	41.1	7.8	142	8.6
General Motors	96.4	4.5	365	109.6[2]
Gulf & Western	29.3	42.1	71	24.5
ITT	160.2	33.6	387	57.2
Marcor	9.0	12.4	110	n.a.[1]
Sears	209.0	34.0	385	51.1
Westinghouse	15.2	7.6	34	7.8
	662.2		1,732	

[1]Not available because parent company had a net loss for 1981.

[2]General Motors and consolidated subsidiaries had a loss of $15 million after taxes; however, after adding $348 million of equity in earnings of such nonconsolidated subsidiaries as GMAC, General Motors had after-tax net income of $333 million.

SOURCE: Harvey Rosenblum and Diane Siegel, *Competition in Financial Services: The Impact of Nonbank Entry*, Staff Study 83-1 (Federal Reserve Bank of Chicago, 1983), Table 1, p. 12.

This trend has continued. In 1981, over 90 percent of Borg-Warner Acceptance Corporation's income and assets came from financing *other* companies' products, and less than 1 percent of Westinghouse Credit Corporation's financing volume was related to Westinghouse products. For General Electric Credit Corporation, this trend toward financing non-G.E. products began in the mid-to-late 1960s; by 1972, less than 10 percent of General Electric Credit's receivables represented G.E. products, and in 1981 only about 5 percent of General Electric Credit's financing was for its parent's products.

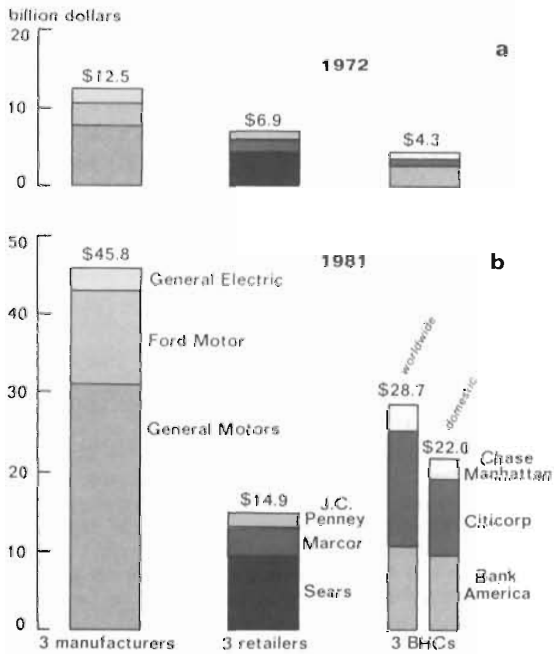
Thus, not only have the earnings from financial activities increased as a percent of total earnings for the majority of the companies listed in Table 1, but many of those companies which were originally captive have evolved to compete increasingly with commercial banks and others in the financial services industry.

Consumer Lending

Over the last decade, some nonfinancial-based companies have made quite remarkable inroads in the area of consumer lending; nonetheless, banks have gained ground in some areas, most notably in credit cards. At year-end 1972, for example, the three largest banks held less consumer installment credit than the three largest nonfood retailers. These, in turn, held less consumer installment credit than three large consumer durable goods manufacturers (see Figure 1a). As shown in Figure 1b, these rankings had changed by year-end 1981. Within this sample of nine companies, bank holding companies experienced the highest growth rate since 1972, in large part due to their credit card operations.

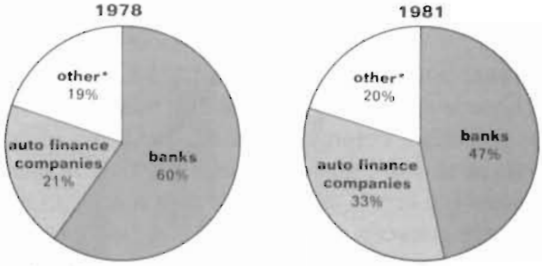
The incursion of nonbank firms in the area of consumer lending is illustrated dramatically in the narrower field of auto loans. As shown in Figure 2, banks have the largest share in auto lending—47 percent at year-end 1981—but this share is down 13 percentage points from its peak

Figure 1
How the big consumer installment credit holders stacked up: 1972 and 1981



SOURCE: Rosenblum and Siegel, Charts 1a and 1b, p. 15.

Figure 2
Car loans: Auto finance companies take a bigger slice of outstanding loans



*Includes credit unions and other finance companies.
SOURCE: Rosenblum and Siegel, Chart 2, p. 22.

in 1978. Over this same three-year period, the share of auto loans held by the captive finance companies of General Motors, Ford, and Chrysler had increased by 12 percentage points to 33 percent of the market. GMAC alone, in 1981, held $28.5 billion of auto loans, almost one-fourth of all auto loans outstanding and double its share of just three years earlier. Bank of America, the largest auto lender among commercial banks, held $2.2 billion of auto loans at year-end 1981, a mere one-thirteenth of the total held by GMAC, far and away the largest consumer lender in the United States and probably the world.

These figures, however, may be somewhat biased by recent events. The soaring cost of funds, binding usury ceilings in many states, and use by General Motors, Ford, and Chrysler of below-market financing rates in an attempt to boost sluggish sales have caused many lenders to exit the auto lending business in recent years.

As shown in Table 2, commercial banks, in 1978, made 58 percent of net new auto loans (new loans extended less liquidations); in 1981, banks' extensions of net auto loans were negative; and in 1982, banks made only 16 percent of the net new auto loans that year. Finance companies, however, made only 25 percent of the net new auto loans in 1978 but accounted for 72 percent of such loans in 1982. The sharp drop-off in new business volume is also particularly noteworthy as it demonstrates a market in a state of flux, a condition conducive to large—even massive—shifts in market shares.

The shift in the consumer lending market away from commercial banks toward finance companies can also be seen in Figure 3. In 1978, commercial banks issued 55 percent of net new installment debt (new loans less liquidations) to households; finance companies accounted for only 22 percent. By 1981, however, these relative shares had more than reversed themselves as commercial banks moved away from consumer installment lending over the 1978-1981 period. In fact, in 1978 commercial banks extended almost $1.20 in new consumer installment credit for every one dollar of consumer installment loans liquidated, but by 1980, they extended only 95 percent for every one dollar of consumer installment loans that were repaid or liquidated. Over this same period, finance companies increasingly entered the consumer lending market; thus, by 1981, finance companies issued 72 percent of net new consumer installment debt while commercial banks issued only 3 percent.

These shifts in market shares may be somewhat distorted by the fact that finance company subsidiaries of bank holding companies are included with finance companies. Further complicating interpretation of the data is the tendency of some banks to sell consumer loans to their finance company affiliates and vice versa. The division between finance companies and banks, however, is correct because banks are regulated very differently than finance companies, regardless of their affiliations.

Also, the shifts in market shares in consumer installment lending are not necessarily permanent but probably reflect cyclical as well

Table 2
Sources of net new automobile credit by holder

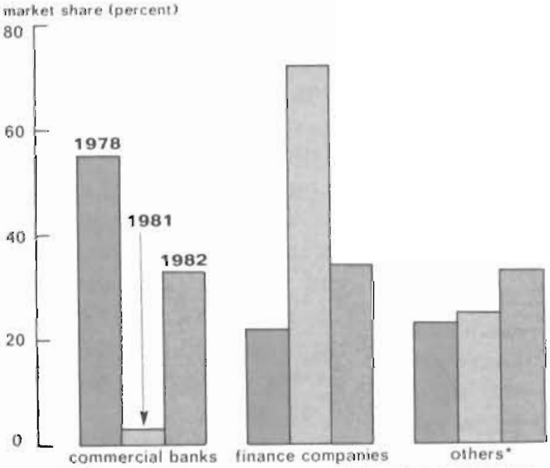
	1978		1981		1982	
	Dollar billion	Percent	Dollar billion	Percent	Dollar billion	Percent
Commercial banks	10.9	58	-3.5	*	.8	16
Finance companies	4.7	25	4.0	*	3.5	72
Credit unions	3.1	17	.9	*	.6	12
	18.7	100	8.4	*	4.9	100

*Percentages not shown because market shares cannot be negative.
SOURCES: U.S. Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin* 68 (May 1982), pp. A42-A43 and *Consumer Installment Credit* G.19 (March 1983).

as secular forces working simultaneously. As can be seen in Figure 3, commercial banks recovered some market share in 1982, as did S&Ls and all other lenders at the expense of finance companies. In fact, finance companies lost almost 38 percentage points in only one year. Furthermore, the comeback of commercial banks and S&Ls in the consumer lending market is likely to continue through 1983 as banks and other depository institutions that have been flooded with new funds in response to the successs of money market deposit accounts (MMDAs), Individual Retirement Accounts (IRAs), and other deregulated deposit instruments become more willing to offer consumer installment loans. Further, S&Ls are likely to maintain a more significant presence in consumer lending than they did in the past as they continue to take advantage of the broader lending powers given them under the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982.

Just as the shift in market share in consumer installment lending has been dramatic, so too has the decline in net *new* loan volume, falling by more than half—to less than $20 billion in 1981 from over $43 billion in 1978. Even more significant was the decline in volume of net new consumer installment loans at commercial banks—down to $0.6 billion in 1981 from $23.6 billion three years earlier. During this same period, auto loans outstanding at commercial banks declined by $2.4 billion; in the prior three-year period (year-end 1978 vs. year-end 1975), auto loans at commercial banks grew by $29 billion.

Figure 3
Consumer loans: banks take a beating



*Includes mutual savings banks, mortgage pools, federal and related agencies, state and local governments, and other lenders.

SOURCES: The Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin* 69 (May 1982), pp. A42-A43 and *Consumer Instalment Credit*, G.19(March 1983).

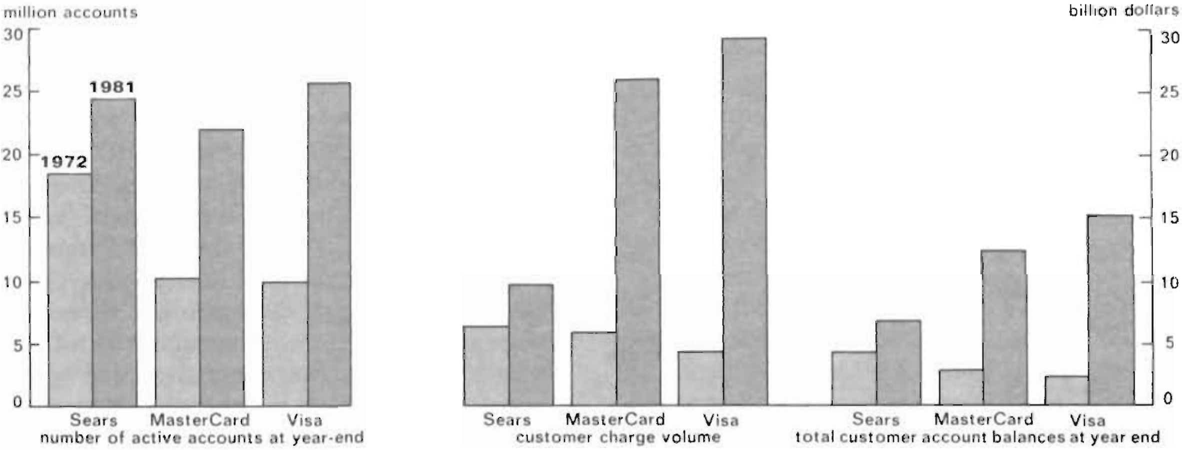
While commercial banks held less in auto loans in 1981 than they held in 1978, their outstanding credit card receivables remained relatively constant at about $17.5 billion over this same three-year period. In fact, it is in the area of charge cards that banks have done best against their nonfinancial-based competitors. In 1972, Sears had the leading credit card in the United States in terms of number of active accounts, charge volume, and customer account balances. By 1981, Visa was the undisputed leader by all three measures with MasterCard not far behind and Sears a distant third except in number of active accounts (see Figure 4). Beginning in 1980 Visa and MasterCard began displacing the cards issued by many retailers such as J. C. Penney and Montgomery Ward.

Whether the success of Visa and MasterCard relative to the Sears card implies a victory for banks over a nonbank competitor is unclear since neither Visa nor MasterCard are banks. They are franchising companies that license a product to franchisees. The original franchisees were banks, but several hundred savings and loan associations, mutual savings banks, and credit unions have become franchisees during the last few years. Indeed, some of Visa's recent growth is attributable to the popularity of Merrill Lynch's Cash Management Account, which includes a Visa card.

Business Lending

Commercial banks remain the predominant source of credit to all businesses, large and small. As can be seen in Table 3, banks have the lion's share of short-term commercial and industrial loans (C&I loans) in the United States. The 15 largest bank holding companies held $141.6 billion of domestic C&I loans at year-end 1981, more than triple the total held by a selected group of 32 nonbank companies, most of whom

Figure 4
The bank cards ace out the biggest retailer on balance and volume



SOURCE: Rosenblum and Siegel, Table 9, p. 23

have made forays into banks' traditional commercial lending activities.[3]

The importance of nonbank lenders should not be underestimated. With $39.4 billion in C&I loans the 15 selected industrial companies were an important factor in the C&I loan market, holding almost three-tenths as much in loans as were booked domestically by the 15 largest bank holding companies. In addition, funds that large firms raise from banks and from the money and capital markets are used to provide loans to many small businesses. This trade credit, although an imperfect substitute for bank credit because it cannot be used to pay other creditors or meet employee payrolls, is the most widely used source of credit for small businesses, both in terms of the percentage of firms utilizing it and in dollar volume. Moreover, at year-end 1981 nonfinancial firms had $53.7 billion of commercial paper outstanding and nonbank financial firms had $77.4 billion of commercial paper outstanding; some portion of this was used to provide credit to businesses.

Banks are also an important source of funds for commercial mortgages and lease financing, but nonbank firms again should not be overlooked in these areas. As shown in Table 3, four insurance-based companies held more commercial mortgage loans at year-end 1981 than did the 15 largest bank holding companies.[4] The 32 selected nonbank firms also held more lease receivables at that time than did the top 15 bank holding companies on a worldwide basis and more lease receivables than did domestic offices of the nation's more than 14,000 insured commercial banks. If the sum of C&I loans, commercial mortgage loans, and business lease financing can be used as a *rough* proxy for total business credit, then it would appear that the 32 selected nonbanking-based firms have made significant inroads into the commercial lending activities of commercial banks.

Deposit-Taking

Not only are banks experiencing competition from nonbanking-based firms in lending areas, but they are also witnessing the same phenomenon in the area of deposit-taking. Substitutes for bank deposits have been around as long as there has been a reasonably efficient secondary market for government and private securi-

[3]These 32 companies were chosen on the basis of their being the most frequently listed nonbanking-based competitors of commercial banks. Many financial-based companies have been excluded because they have demonstrated little or no inclination to invade the turf of commercial banks.

[4]Insurance companies have played a major role in commercial mortgage lending for many years. Further, many banks do not have the ability to hold long-term commercial mortgages because of the short-term nature of their funds.

Table 3

Business lending by selected nonbanking-based firms and bank holding companies at year-end 1981

	Commercial and Industrial Loans	Commercial Mortgage Loans	Lease Financing	Total Business Lending
	(.	$ million	. . . .	)
15 Industrial/Communications/ Transportation†	39,365	1,768	14,417*	55,550
10 Diversified Financial†	3,602	3,054	1,581*	8,237
4 Insurance-Based	399	35,506	892*	36,797
3 Retail-Based	606	—	—	606
	43,972	40,328	16,890*	101,190
15 Largest BHCs				
Domestic	141,582	19,481	14,279*	175,342
International	118,021	5,046	—	123,067
Total, Top-15 BHCs	259,603	24,527	14,279	298,409
Domestic Offices, All Insured Commercial Banks	327,101	120,333**	13,168	460,602

*Includes domestic and foreign lending and may include leasing to household or government entities.

**Includes all real estate loans except those secured by residential property.

†Financing by banking and savings and loan subsidiaries has been subtracted.

SOURCE: Harvey Rosenblum and Diane Siegel, *Competition in Financial Services: The Impact of Nonbank Entry*, Staff Study 83-1 (Federal Reserve Bank of Chicago, 1983), Table 10, p. 26.

ties. Treasury bills and repurchase agreements, for example, are close substitutes for bank deposits, including demand deposits.

In 1973 a closer substitute for bank deposits emerged—money market mutual funds (MMFs). While not a big threat to banks when interest rates were relatively low, MMFs became very successful when rates rose, growing from only a few billion dollars in "deposits" in 1975 to over $230 billion by December 1982 when they reached their peak. At that time, Merrill Lynch alone managed $50.4 billion in MMF assets, and the Dreyfus Corporation managed $18.5 billion. Originally offered by nonbank financial firms such as Dreyfus and the Fidelity Group, MMFs attracted nonfinancial-based firms as well. Sears began offering the Sears U.S. Government Money Market Trust in late 1981 and later acquired Dean Witter Reynolds, a brokerage firm managing five MMFs.

Although MMFs do compete with bank deposits, few nonbank companies rely to any significant extent upon deposits as a source of funds to finance the loans extended to their customers. Mostly, their funds are raised in the money and capital markets at competitive rates; consequently, the profit margins of most nonbank companies which have financial activities are not, and have never been, dependent upon the Regulation Q franchise. It has been estimated that roughly half of the 1980 profits of 31 of the 50 largest U.S. banks could be attributed to their ability to pay below-market rates on savings accounts.[5] Thus, the continued phase-out of Q-ceilings is unlikely to damage the market position of nondepository firms in lending.

The Banks' Responses to Nonbank Competition

Commercial banks, as well as other depository institutions, have attempted to meet the nonbank challenge by offering some products and services—such as MMFs and discount brokerage services—that had become the domain of nonbank financial firms (see box, chronology 1). In addition, banks and other depository institutions have tried to circumvent regulatory geographic barriers to compete on an even keel with their nonbank rivals (see box, chronology 2).

[5]Alex J. Pollock, "The Future of Banking: a National Market and Its Implications," in *Proceedings of a Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago, 1982, pp. 31-36.

Products and Services

Banks and other depository institutions have not stood idle while deposits left their low-yielding accounts for MMFs. As shown in chronology 1, banks and thrifts have designed various products to compete with MMFs and, at the same time, to skirt a number of competition-inhibiting or cost-raising regulations. The Bank of California, for example, tried to shield an MMF-like account from interest rate ceilings by housing it in Bancal's London branch, and Orbanco proposed a note that would pay market rates and have transaction features. These two schemes were stopped by the Federal Reserve Board, but other innovations have met with more success. Northwestern National Bank, for instance, began allowing its customers to borrow money on their six-month money market certificates through checking accounts in April 1981, and Talman Home, Chicago, introduced its Instant Cash Account in September 1982.

While some depository institutions created products to compete with MMFs, others decided to join them rather than try to beat them. Banks and thrifts began collaborating with money fund managers like Dreyfus and Federated Securities to offer sweep accounts—accounts that sweep idle cash balances exceeding some predetermined level into high-yielding MMFs.

Finally, banks and thrifts no longer had to try to circumvent regulations by linking up with money fund managers in order to offer their customers MMF-like products. In early October 1982, the Congress passed, as part of the Garn-St Germain Depository Institutions Act of 1982, new legislation which permits banks and other depository institutions to offer the Money Market Deposit Account, and in December 1982, the DIDC authorized the Super NOW account. Both are designed to compete directly with MMFs.[6]

Another area dominated by nonbank financial firms which banks have sought to enter is discount brokerage services. Generally, banks have taken one of three paths in offering these services: collaborating with discount brokerage firms, acquiring existing brokerage firms, or establishing discount brokerage subsidiaries of their own.

As shown in chronology 1, many banks and thrifts have taken the first route, hooking up with brokers such as Fidelity Brokerage Services and Quick & Reilly. Some, however, have opted for one of the other two routes. For example, Security Pacific National Bank, which at first offered discount brokerage services through Fidelity, acquired Kahn & Company, a Memphis-based discount brokerage, in October 1982. In November 1982, Security Pacific formed a subsidiary to provide back office support for other banks entering the discount brokerage field. More recently, BankAmerica Corporation acquired Charles Schwab & Company, the nation's largest discount broker. Taking the third path, in November 1982, three S&Ls started Invest, a brokerage service which S&Ls nationwide can offer.

In addition, since mid-1981 when J. P. Morgan & Co. formed a subsidiary to trade financial futures for Morgan Guaranty's account, banks have increasingly been seeking to trade in the financial futures market for their own accounts as well as for their customers. Before they can act as brokers for third parties, however, banks must first get approval from the Comptroller of the Currency or, in the case of bank holding companies, from the Federal Reserve Board. Then they must apply to the Commodity Futures Trading Commission (CFTC) for registration as brokers. Among those that have cleared both stages of the regulatory process are J. P. Morgan & Co., North Carolina National Bank, Bankers Trust, and First National Bank of Chicago.

Banks are also expanding into less finance-related fields such as data processing and telecommunications. For example, Citicorp was recently given permission to offer an expanded range of data processing and transmission services[7] and, in June 1982, it purchased two trans-

[6]Both the MMDA and the Super NOW account require an initial deposit of $2,500, are free of interest rate ceilings, and are federally insured; however, depositors can write only three checks per month on an MMDA whereas they can write an unlimited number of checks on a Super NOW. Super NOW accounts are restricted to individuals, certain non-profit corporations, and governmental units, whereas MMDAs can be offered to any entity.

[7]*Federal Reserve Bulletin*, August 1982, p. 505.

Chronologies of change

1. Banks fight back

Apr 1981 Citibank and Northwestern National Bank allow their customers to borrow money on their six-month money market certificates through a checking account.

May 1981 The Bank of California NA, San Francisco, introduces a new account to compete with money market funds. Because the account is housed in the bank's London branch, BanCal says it is not subject to interest rate ceilings and reserve requirements, but the Fed disagrees.

May 1981 J.P. Morgan & Co. forms a subsidiary to trade financial futures for Morgan Guaranty's account. In July 1981, the Federal Reserve Board allows Morgan Guaranty to execute trades for its customers; in December 1982, the Commodity Futures Trading Commission approves.

Sep 1981 Dreyfus Service Corp. sweeps excess cash from bank accounts into its money market funds, and other firms follow Dreyfus' lead.

Nov 1981 BankAmerica Corp. plans to acquire Charles Schwab & Company, the nation's largest discount brokerage firm; the Federal Reserve Board approves the acquisition early in 1983.

Jan 1982 Banks and thrifts collaborate with brokerage firms to offer discount brokerage services to customers of the banks and thrifts.

Mar 1982 Orbanco Financial Services Corp., a Portland, Oregon, holding company, proposes a note with a minimum denomination of $5,000, which bears market interest rates, and which has transactions features. The Federal Reserve Board, however, disallows the note.

May 1982 Three S&Ls receive permission to start a joint securities brokerage service that S&Ls nationwide can use to offer investment services to their customers. The service, known as Invest, begins operations in November.

Jun 1982 Citicorp purchases two transponders on the Westar V satellite in preparation for global banking.

Jul 1982 The Federal Reserve Board allows Citicorp to offer various data processing and data transmission services nationwide through a new subsidiary, Citishare Corp.

Aug 1982 The Comptroller of the Currency allows First National Bank of Chicago to form a subsidiary to trade in the futures market for its customers. In January 1983, the Commodity Futures Trading Commission approves.

Sep 1982 Talman Home Federal Savings and Loan Association introduces its Instant Cash Account to compete with money market funds. The account requires a $5,000 minimum balance and pays the rate of a 6-month CD.

Sep 1982 North Carolina National Bank's NCNB Futures Corp. receives final approval from the Commodity Futures Trading Commission to act as a futures commission merchant.

Sep 1982 The Federal Reserve Board allows Bankers Trust New York Corp. to buy and sell futures contracts for its customers through a new subsidiary, BT Capital Markets Corp. In January 1983, the Commodity Futures Trading Commission approves.

Sep 1982 Poughkeepsie Savings Bank applies to the FHLBB to acquire Investors Discount Corp., a Poughkeepsie discount brokerage firm.

Oct 1982 The Comptroller of the Currency allows Security Pacific, Los Angeles, to acquire Kahn & Co., a Memphis-based discount brokerage firm.

Oct 1982 The DIDC authorizes an account which federal depository institutions can offer and which is "directly equivalent to and competitive with money market funds."

Nov 1982 Security Pacific National Bank forms a subsidiary, Security Pacific Brokers Inc., to provide back office support for other banks which offer discount brokerage services.

Dec 1982 The DIDC authorizes a Super-NOW account which federal depository institutions can offer on January 5, 1983.

2. Interstate barriers crumble

Mar 1980 South Dakota passes legislation which allows out-of-state bank holding companies to move credit card operations to South Dakota. Three years later, the state passes a new bill that allows out-of-state bank holding companies to own state chartered banks which can own insurance companies.

Feb 1981 Delaware passes an out-of-state banking bill which opens the state to major money center banks.

Jun 1981 Citibank establishes Citibank (South Dakota) NA in Sioux Falls to handle its credit card operations.

Aug 1981 Marine Midland Banks, Inc., Buffalo, New York, infuses $25 million into Industrial Valley Bank and Trust Company, Philadelphia, by buying newly issued common stock and nonvoting preferred stock with warrants to buy an additional 20 percent of Industrial Valley's common stock should interstate banking be permitted.

Sept 1981 United Financial Corp., San Francisco, a subsidiary of National Steel and parent of Citizens Savings and Loan, acquires an S&L in New York and one in Miami Beach. The Combined S&Ls later become First Nationwide Savings.

Nov 1981 Casco-Northern Corp., Portland, Maine, parent of Casco Bank and Trust Company, sells First National Boston Corp. 56,250 shares of its convertible preferred stock and warrants to buy additional common shares. In March 1983, First National Bank of Boston Corp. agrees to acquire Casco-Northern.

Dec 1981 J.P. Morgan & Company establishes Morgan Bank (Delaware), to engage in wholesale commercial banking.

Dec 1981 Home Savings and Loan Association, Los Angeles, acquires one Florida thrift and two in Missouri. In connection with the acquisitions, Home Savings and Loan becomes Home Savings of America.

Jan 1982 North Carolina National Bank Corp. acquires First National Bank of Lake City, Florida, by using a legal loophole in a grandfather clause.

Jan 1982 AmSouth Bancorp. of Alabama, South Carolina National Bank Corp. and Trust Company of Georgia plan to merge into a single holding company if and when interstate banking is permitted. Until then, each is buying $2 million of nonvoting preferred stock in the other two.

Jan 1982 Home Savings of America, Los Angeles, acquires five Texas savings associations and one in Chicago.

Mar 1982 Marine Midland Banks, New York, invests $10 million in Centran Corp., Cleveland, in the form of newly issued nonvoting preferred stock and warrants to buy over 2 million shares of Centran's common stock should interstate banking be permitted.

Jun 1982 Alaska's new banking law permits out-of-state banks to acquire Alaskan banks without the states of those banks enacting reciprocal legislation.

Jul 1982 New York legislation amends the state's banking law to allow out-of-state bank holding companies to acquire control of New York banks provided that the states of these banks reciprocate.

Aug 1982 The Federal Reserve Board and the shareholders of Gulfstream Banks Inc., Boca Raton, Florida, approve the acquisition of Gulfstream Banks by North Carolina National Bank Corp.

Sep 1982 In the first reciprocal interstate bank acquisition between New York and Maine, Key Banks Inc. of Albany agrees to acquire Depositors Corp. of Augusta; the acquisition is expected to be completed by the end of 1983.

Dec 1982 The Federal Reserve Board allows Exchange Bancorp., Florida, to merge into North Carolina National Bank Corp., and the Fed approves the merger of Downtown National Bank of Miami into NCNB/Gulfstream Banks Inc.

Dec 1982 Both houses of the Massachusetts State legislature pass an interstate banking bill which allows Massachusetts banks to expand into other New England states on a reciprocal basis. The law is effective in 1983.

ponders on the Westar V satellite, thus becoming the first financial institution to own transponders in space.

Geographic Barriers

Banks seem to be meeting the challenges of nonbank competition in many of their new rivals' product lines, but banks do not yet enjoy the same geographic freedom as their nonbank competitors. Although many of the products and services which banks and bank holding companies provide are offered nationwide, such as those provided through nonbank subsidiaries like consumer finance and mortgage banking companies, the interstate expansion of a ***bank's*** physical facilities is still generally prohibited. Nonetheless, as shown in chronology 2, banks and thrifts are preparing for the legalization of interstate banking, and—through mergers, acquisitions, affiliations, relaxations of some state laws, and technological advances—interstate banking is slowly becoming a reality.

Agreements to merge are the most common way in which banks and thrifts have been preparing for interstate banking. Usually, one institution agrees to invest in another by purchasing nonvoting preferred stock with warrants to buy additional shares of common stock should interstate banking be allowed. Although Citicorp was the first to use such a maneuver, many others have followed. In this manner, for example, Marine Midland Banks, New York City, invested $25 million in Industrial Valley Bank and Trust Company, Philadelphia, and $10 million in Centran Corporation, Cleveland.[8]

Some interstate mergers and acquisitions, however, have already taken place. In January 1982, Home Savings of America, Los Angeles, acquired five ailing savings associations in Texas and one in Chicago after acquiring a troubled Florida thrift and two in Missouri. Also in January 1982, North Carolina National Bank Corporation acquired First National Bank of Lake City, Florida, through a loophole in a grandfather clause, and later expanded further in that state. Although the acquisitions by Home Federal and those by North Carolina National Bank Corporation are different in nature and purpose, five or ten years from now their effects will be the same.

In some instances, interstate banking has been encouraged by individual states. In early 1980, South Dakota passed a law which allows out-of-state bank holding companies to establish banks to house credit card operations, and in June 1981, Citicorp moved its credit card operations to the newly established Citibank (South Dakota). In March 1983, South Dakota passed another law which allows out-of-state bank holding companies to acquire or charter state banks, which could own insurance companies. Delaware passed its out-of-state banking law in February 1981 to encourage banks to relocate certain activities in the state; since then 12 institutions have established banks in Delaware, including five from New York, four from Maryland, and three from Pennsylvania. However, these new banks do not compete with Delaware banks in general banking operations. In June 1982, Alaska enacted legislation that allows out-of-state banks to acquire Alaskan banks without reciprocal legislation on the part of the states of those banks. New York, Massachusetts, and Maine enacted similar legislation but require reciprocity. Out-of-state banks, therefore, can compete with banks in Alaska, New York, Massachusetts, and Maine, but Massachusetts limits interstate banking to the New England states.

Interstate banking also occurs through banks' and thrifts' affiliations with nationwide brokers and investment firms. Alliances that would have been termed "unholy" not long ago are commonplace today. Through its network of some 475 offices, Merrill Lynch has marketed All Savers Certificates for Bank of America, Crocker National Bank, and two S&Ls, one in Florida and the other in Washington. Merrill Lynch also maintains a secondary market for retail CDs issued by banks and S&Ls and acts as a broker in the placement of retail CDs issued by more than 20 banks and thrifts, thus giving each of them a nationwide reach. Merrill Lynch is not alone in this regard but is joined by several other com-

[8] The Federal Reserve Board permits these limited interstate banking activities if the acquiring company holds no more than 24.9 percent of the nonvoting shares, holds no more than 5 percent of the voting stock, and exercises no control over the bank in which the investment is being made.

panies including Sears/Dean Witter, Shearson/American Express, and E. F. Hutton. Together these four firms operate roughly 1,325 offices throughout the United States. Thanks to these and other firms like them, a comparatively small depository institution such as City Federal Savings and Loan of Elizabeth, New Jersey, can now compete toe-to-toe on a nationwide basis with Bank of America in the sale of federally insured retail CDs.

The importance of the cooperative affiliations between brokers and depository institutions should not be underestimated, for it may represent one of the most significant reductions in entry barriers into the financial services business. No longer is deposit and loan growth of a de novo bank or S&L constrained by its ability to generate deposits from its local customers. To the extent that it has profitable lending opportunities, a new depository institution can engage in liability management through the sale of brokered, insured *retail* deposits by paying above the going market rate. The availability of federal deposit insurance should make depositors virtually indifferent to the identity of the institution they deal with. It is now conceivable that a de novo bank or S&L could develop a billion-dollar deposit base within a year or two of its opening.

Conclusion

Over the last decade, competition in financial services has increased as the number of firms grew and the geographic market became more and more national. Furthermore, deregulation tends to be accompanied by unbundling of products, and this has been the case in the financial services industry. Nonbank firms have been able to target and successfully enter the major and minor product lines of commercial banks. Thus the preeminent position of commercial banks has been eroded somewhat in consumer lending, business lending, and deposit-taking. But as nonbank rivals encroached upon banks' traditional territory, banks responded where possible by invading some of their new competitors' product lines and by attempting to compete on a nationwide basis as do these competitors.

Thus, by 1983, the line of commerce that was once called commercial banking has evolved into a new line of commerce, the provision of financial intermediation services. Yet, the courts have continued to delineate commercial banking as a distinct line of commerce, separate from other financial services. In the eyes of the courts, banks compete only with other banks, but not with S&Ls, credit unions, finance companies, mutual savings banks, insurance companies, and so forth. This has been the prevailing view of the courts for two decades, having been decided in *Philadelphia National Bank*[9] in 1963.

The evidence provided in this article illustrates quite clearly that technological advances and long overdue statutory and regulatory changes have blurred the distinctions between financial intermediation services offered by old-line, traditional financial institutions such as banks and S&Ls and the services offered by the financing arms of manufacturers, retailers, and diversified financial conglomerates. In the longer run, the survivors will be the low cost producers—irrespective of their charters. Perhaps then the line of commerce definition will be judicially or legislatively revised.

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[9] *United States v. The Philadelphia National Bank* et al., 374 U.S. 321, 915 (1963).

This article is a brief summary of a more detailed monograph, *Competition in Financial Services: The Impact of Nonbank Entry*, by Harvey Rosenblum and Diane Siegel, Staff Study 83-1.

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