New directions for economic development—the banking industry

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Projected job growth in the service industries has stimulated interest in those industries as a source of economic development and employment growth.

One of the service industries that has generated particular interest has been the banking industry. Technological improvements no longer require that banking operations be located in close proximity to a bank's customers. The elimination by some states of restrictions on banking, such as geographic limits and usury laws, has provided a means of attracting banking operations from other states. The results have been an acceleration of the deregulation trend as states affected by the possible or actual loss of banking employment enact similar measures to retain and attract banking operations and economic benefits for consumers.

South Dakota and Delaware were pioneers in targeting the banking industry for economic development. The efforts of South Dakota were directed toward credit card operations. Delaware targeted not only credit card operations, but also wholesale banking and international banking.

General interstate banking legislation provides an opportunity for bank holding companies to transfer operations to banking subsidiaries located in states with the greatest opportunities for profitable operations. It also provides geographic diversification of risk.

This paper looks at the efforts and results in South Dakota and Delaware in developing the banking industry in their states. It also looks at the current status of interstate banking, i.e., where bank holding companies are establishing or acquiring new out-of-state banking subsidiaries and the resulting effects on asset, deposit, and employment growth in the individual states.

Projected job growth all in services

More than 21 million jobs are projected to be added to the United States economy between now and the end of the century, according to the Bureau of Labor Statistics. (See Table 1.) Of the increase, virtually all will be in the service-producing industries. Although some of the goods-producing industries, which include manufacturing, mining, and construction, are projected to grow, others will decline, and as a result, no net change in employment is expected in the goods-producing sector.

Table 1
Projected employment growth, 1986-2000

Industry	Number (mil.)	Percent change
Total	21.4	19
Nonfarm wage and salary	20.1	20
Goods-producing	*	*
Mining	*	-8
Construction	.9	18
Manufacturing	-.8	4
Service-producing	20.1	27
Transportation and public utilities	.5	9
Wholesale trade	1.5	27
Retail trade	4.9	27
Finance, insurance, and real estate	1.6	26
Services	10.0	44
Government	1.6	10
Agriculture	-.3	-10
Private households	*	-2
Nonfarm self-employed and unpaid family workers	1.7	20

*Less than .05

Source: Kutscher, Ronald E., "Projections 2000: Overview and implications of the projections to 2000," Monthly Labor Review, Vol. 100, pp. 3-9, September 1987.

Financial services are among the service-producing industries expected to continue to show substantial rates of output growth. Although employment in finance is expected to grow less rapidly than in the recent past, there are expected to be 262,000 more jobs in banking, 495,000 more in credit agencies and in-

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vestment offices, and 134,000 more in security and commodity brokerages and exchanges by the year 2000.

State opportunities for financial centers

Projected growth in employment in financial services has encouraged states and cities interested in economic development to establish financial centers. Among the incentives offered to encourage financial services firms, particularly banking institutions, to locate in an area have been the elimination of interest rate ceilings on loans, lower tax rates on bank net income, and permission for interstate banking.

In 1978, the Supreme Court, in *Marquette National Bank v. First of Omaha Service Corporation,* 439 W.S. 249 (1978), affirmed the right of a national bank to charge interest rates to out-of-state credit card customers at the rate permitted by the law of its home state. This meant that national banks in states with higher or nonexistent ceilings on consumer lending rates could export that rate to consumers in states with lower ceiling rates.

The ability to offer more pricing flexibility in consumer lending presented an opportunity for a state to increase commercial banking transaction activity and employment. By increasing or eliminating ceiling rates on consumer loans and granting permission to out-of-state bank holding companies to own national bank subsidiaries, state legislators could encourage such companies to establish subsidiaries engaged primarily in national credit card operations. Subsidies or tax incentives, frequently used by states to attract manufacturing companies, were usually not involved. Minimum employment levels were usually the only requirement in implementing the legislation. In addition the legislation usually included restrictions on the operations of the bank subsidiary of the out-of-state bank holding company to protect existing in-state banks, which also benefited from the changes in usury rates.

In addition to nonexistent or nonbinding usury rates, some states offered other inducements in targeting commercial banks. These included permission to charge annual fees for credit cards or loans and lower income tax rates on bank income. The soliciting state could also offer lower cost operations and a plentiful, educated labor force.

Competition for the out-of-state bank's operations came from other states. These states sought either to retain the operations of their resident banks or to attract operations of banks located in other states.

Technological improvements have facilitated the ability of bank holding companies to locate certain banking operations in other states. Thanks to electronic data transmission and funds transfers and other communications technologies banking operations no longer need be carried on in close proximity to the majority of a bank's customers.

The marketing strategy of some states was to be financial pioneers. If successful, the pioneer states would become established financial centers. Once established, bank operations were unlikely to move back to the home state or elsewhere unless a new location could demonstrate distinct advantages.

States adjacent to the pioneers have generally been follow-the-leader states. They have enacted similar legislation when faced with the prospect of losing banking operation facilities to neighboring states.

Pioneer states: South Dakota and Delaware

South Dakota was the first state to enact commercial banking legislation specifically aimed at bringing out-of-state banking operations to the state to create jobs, expand the economy, and increase tax revenues. In February 1980, South Dakota removed all usury ceilings for credit card loans and other types of consumer lending effective May 1. Commercial banks, savings banks, savings and loan associations, and credit unions were previously held to a 12 percent usury ceiling. In March, the state further amended its banking laws to permit an out-of-state bank holding company to establish a single state or national de novo bank and move its credit card operations there. Such a bank was limited to a single banking office and was to be operated in a manner and at a location that would not attract customers from the general public. (Subsequent legislation has eliminated most of these original restrictions.)

New York's Citicorp was the first out-of-state bank holding company to establish a new national bank in South Dakota. The bank, Citibank (South Dakota), N.A., at Sioux Falls,

Table 2

Growth at commercial banks 1980 - 1987

	United States		South Dakota		Delaware	
	Amount	Percent	Amount	Percent	Amount	Percent
Total domestic assets (bil.)	$1,068.9	70	$15.3	300	$39.3	1,067
Total loans	782.7	96	13.2	453	35.3	1,953
Loans to individuals	153.3	85	12.7	2,549	26.3	4,100
Credit card loans	72.4	243	12.3	207,876	25.0	24,375
Employment	96,566	7	3,281	75	13,536	347

was organized to engage principally in nationwide consumer credit card lending activities then currently conducted by Citibank's New York banks.[1] At the end of 1987, it was the largest commercial bank in South Dakota, with domestic assets of $12.0 billion, total loans to individuals of $11.6 billion, and 3,462 employees. (See Figure 1.)

Other out-of-state bank holding companies from Texas and Nebraska also established subsidiaries in South Dakota, primarily to offer credit card services. At the same time, two large bank holding companies with headquarters in Minnesota expanded consumer loans and employment at existing subsidiary banks in South Dakota. Currently, four of the five largest commercial banks in South Dakota are subsidiaries of out-of-state bank holding companies and all are located in Sioux Falls.

As a result of the acquisitions and expansions of subsidiary banks by out-of-state bank holding companies, South Dakota experienced the fastest rate of growth in the U.S. in loans to individuals for credit cards at commercial banks. Additionally, its rates of growth in total domestic assets, total loans, loans to individuals, and employment were second only to Delaware. (See Table 2.)

Delaware has long been a state with generally less restrictive requirements for business corporations. About 179,000 companies, including 56 percent of the Fortune 500 firms and 45 percent of the companies listed on the New York Stock Exchange, are incorporated in Delaware.

Since 1981, legislation has been directed more specifically toward the development of the financial services industry, with emphasis on commercial banking.

The Financial Center Development Act of 1981 (FCDA) was signed into law on February 18, 1981. It permitted an out-of-state bank holding company to establish a de novo bank with a single office operated in a manner and at a location not likely to attract customers from the general public in Delaware. However, the bank could operate to attract and retain customers with whom the bank, the out-of-state holding company, or such holding company's bank or nonbanking subsidiaries had business relations. The bank was required to employ within one year not less than 100 persons in the state in its business.

In addition, FCDA essentially eliminated interest rate ceilings on all types of loans including bank revolving credit (i.e., credit cards) and bank closed-end credit and permitted banks to charge fees "for the privileges made available to the borrower under the plan" (i.e., annual card fees).

The Delaware legislation also included an attractive bank tax structure. The rate of tax on bank net income was revised to 8.7 percent of net income not in excess of $20 million; 6.7 percent of net income over $20 million but not over $25 million; 4.7 percent of net income over $25 million but not over $30 million; and 2.7 percent of net income over $30 million. The combined state and local marginal tax rate in Wilmington, Delaware, has been calculated at 4.5 percent, compared to 24.2 percent in New York City, 11.7 percent in Philadelphia, 10 percent in Pittsburgh, and 6.5 percent in Chicago.

The first acquisition approved by the Federal Reserve Board of Governors under Delaware's FCDA of 1981 was that by J.P. Morgan & Company, Incorporated, a New York bank holding company, of Morgan Bank

Table 3

Delaware banking industry changes December 1980 - December 1987

Bank group	Total domestic assets Amount*	%	Total domestic loans Amount*	%	Employees Amount	%
Continuing banks	4,062.5	10.3	3,498.7	9.9	1,218	9.0
FCDA banks	23,263.4	59.1	20,688.7	58.6	6,400	47.2
CCBA banks	1,390.0	3.5	1,328.1	3.8	158	1.1
Nonbank banks	10,659.7	27.1	9,781.3	27.7	5,793	42.7
Subtotal	39,375.6	100.0	35,296.8	100.0	13,569	100.0
Discontinued banks	(41.0)		(22.6)		(33)	
Total	39,334.6		35,274.2		13,536	

Bank group	Loans to individuals Amount*	%	Credit card loans Amount*	%	Total deposits Amount*	%
Continuing banks	1,298.1	4.9	747.2	3.0	3,473.0	20.6
FCDA banks	14,064.6	53.6	13,575.4	54.4	7,332.9	43.4
CCBA banks	1,328.8	5.1	1,328.8	5.3	612.4	3.6
Nonbank banks	9,570.8	36.4	9,305.0	37.3	5,474.8	32.4
Subtotal	26,262.3	100.0	24,956.4	100.0	16,893.1	100.0
Discontinued banks	(2.7)		0		(36.0)	
Total	26,259.6		24,956.4		16,857.1	

*mil.$

(Delaware), on November 19, 1981.[2] The newly chartered bank was formed to engage in wholesale banking to domestic corporations and financial institutions nationally and internationally. The bank also planned to participate in large loans made by Delaware banks and in loans to Delaware banks. In its order, the Board stated, "This increase in available capital should have a positive impact on economic development in Delaware."

On June 6, 1983, Delaware enacted two additional state banking laws, the Consumer Credit Bank Act of 1983 (CCBA) and the International Banking Development Act of 1983 (IBDA). The CCBA permitted an out-of-state bank holding company to establish a consumer credit bank which was limited to conducting a nationwide credit card or consumer loan business. Capital requirements were minimal and there was not an employment requirement. The bank however was required to be allied with a qualified credit card processing association that must hire at least 250 employees in its first three years in Delaware.[3] The International Banking Development Act of 1983 was specifically aimed at attracting foreign banks and foreign capital but it also encouraged the establishment of internationally-oriented Edge Act banks and international banking facilities. It removed the usury ceiling on extensions of credit by international banking facilities, eliminated reserve requirements for such facilities, and also exempted their net income from Delaware's state franchise tax.

The Delaware legislation eliminating interest rate ceilings on consumer loans and implementing an attractive tax-rate schedule on bank net income has also encouraged the acquisition of so-called nonbank banks by out-of-

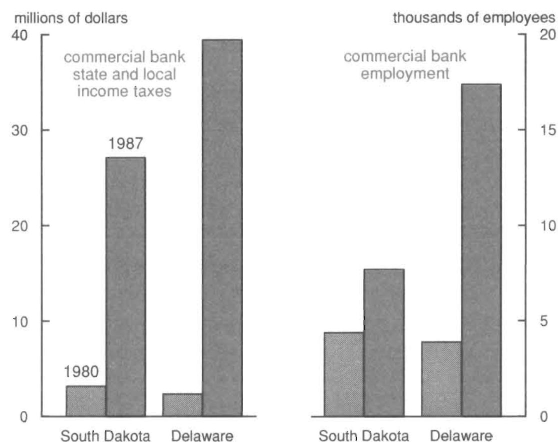
state companies. Such nonbank banks have usually been acquired or established by nonbank holding companies, primarily for the purpose of offering consumer loans and credit cards, or alternatively, offering commercial loans but not accepting demand deposits.[4]

The major contributors to the growth in the commercial banking industry in Delaware have been the FCDA banks.(See Table 3.) By the end of 1987, 17 FCDA banks had opened and one was pending. Eight are subsidiaries of bank holding companies located in New York, and are variously engaged in wholesale banking, cash management services, nationwide commercial lending, as well as consumer lending and credit card operations. FCDA banks that are subsidiaries of bank holding companies in Georgia, Maryland, Virginia, North Carolina, and Pennsylvania, are primarily engaged in consumer lending and credit card operations.

Eight nonbank banks were in operation at the end of 1987 and have been the second major source of growth in commercial bank assets and employment, particularly recently. Increases in total domestic assets and total loans at nonbank banks have been primarily the result of the increases in loans to individuals for credit cards. Growth in employment has been particularly strong at nonbank banks compared to other banks in Delaware. Of the 13,536 employment increase at Delaware commercial banks from 1980 to the end of 1987, 5793 or 43 percent was at nonbank banks. Employment increased 3168 alone at Greenwood Trust Company in New Castle, Delaware, after it was acquired by a subsidiary of Sears, Roebuck and Company in January 1985 and began offering the new Discover credit card.

The limited-purpose CCBA banks have had a smaller impact on the growth of assets, total loans, and employment. Part of this is attributable to the more recent enactment of the CCBA legislation. Most of the impact of the CCBA has been the result of the aggregate growth of credit-card related loans to individuals. The total effect of the CCBA banks on employment does not appear in the banks' figures because the increases in employment are primarily at the credit-card processing associations with which the CCBA banks are usually affiliated. In fact, only 158 employees were reported at the nine CCBA banks in operation at the end of 1987.

Figure 1
The rewards of innovation



Delaware's eleven continuing commercial banks also benefited from the legislation to encourage the expansion of banking employment. They experienced aggregate growth in domestic assets, loans, deposits, and employment well above the national average. Growth in credit card loan balances was a major contributor to the increase in total domestic assets at the continuing banks. A substantial amount of the increase was at Mellon Bank Delaware, N.A., which had become a subsidiary of the Mellon National Corporation, Pittsburgh, following approval of the merger of Mellon with The Girard Company on March 7, 1983. The elimination of the usury ceiling in Delaware provided an incentive for the Pennsylvania bank holding company to expand credit card operations at the Delaware subsidiary bank.

In addition, CCBA provided an opportunity for Delaware banks to serve as a qualified credit card processing association. Growth in commercial and industrial loans and real estate loans at the banks was also well above the national average.

Nearby states: playing follow-the-leader

After the successes in South Dakota and Delaware, other states, particularly those nearby, found it necessary to play follow-the-leader. Some of the banks in these nearby states were either moving their credit card operations to South Dakota or Delaware or were

threatening to do so. These states, particularly New York, Nebraska, Virginia, Maryland, and Pennsylvania found it necessary to take immediate action to retain a competitive edge in the banking industry.

New York was among the first states affected by the moves, real and threatened, of its banks to South Dakota and Delaware. New York's response was to enact legislation, effective January 1, 1981, that eliminated ceilings on interest rates for credit cards and most personal loans and permitted credit card fees.

The New York legislation, however, did not reverse the planned move by Citicorp of its credit card operations from New York to South Dakota. Furthermore, the state was unable to compete very successfully for some of its other banks' operations with Delaware, which was much closer to New York and offered both the absence of a usury rate and much lower tax rates on bank net income. Consequently, many of the large New York bank holding companies established subsidiary banking operations there.

Nebraska, South Dakota's neighbor, found it necessary to enact banking legislation similar to that in South Dakota. In early 1983, First National of Nebraska, Inc., Omaha, agreed to acquire Valley State Bank, Yankton, South Dakota, just across the South Dakota-Nebraska border.[5] The acquisition's purpose was to direct the expansion of the credit card business of its subsidiary, First National Bank of Omaha, to the Yankton bank. First National, the largest credit card issuer in Nebraska, wanted to take advantage of the absence of usury restrictions in South Dakota.

In response to the First National move and the apparent success of South Dakota in attracting out-of-state banking operations, Nebraska approved similar legislation on April 18, 1983. The legislation eliminated all usury ceilings on credit cards and allowed out-of-state bank holding companies to acquire a single de novo bank in Nebraska whose services were limited to credit card operations at one office.

Following the passage of the Nebraska legislation, First National Bank of Omaha said that it would expand its credit card operations in Omaha as well as open the credit card subsidiary bank in Yankton, South Dakota.

Virginia, near Delaware, also sought to retain the credit card operations of its banks. It eliminated the interest rate ceiling on bank credit card loans effective April 1, 1983. Unlimited annual fees were also permitted.

On March 15, 1983, Virginia approved legislation that permitted so-called Financial Service Center Banks. The legislation authorized an out-of-state bank holding company to acquire a de novo bank, provided the bank was created primarily to engage in a significant multi-state credit card operation. The bank could also engage in limited deposit-taking and commercial loan operations and was therefore subject to regulation as a bank.

First Kentucky National Corporation, Louisville, Kentucky, in April 1984, was the first out-of-state bank holding company to acquire a de novo bank for credit card operations in Virginia.[6] The bank was acquired to transfer the credit card operations of its Louisville Bank to the Virginia bank in light of Virginia's more liberal revolving credit interest rate and credit card fee laws.

Maryland. Efforts in Maryland to increase or eliminate interest rate ceilings and permit credit card fees encountered strong opposition from consumer groups and labor organizations. Legislation was enacted, effective July 1, 1982, to raise the interest rate ceiling to permit banks to charge up to 24 percent interest on outstanding balances on credit cards. Annual fees on credit card accounts, however, were not permitted and other restrictions on credit card operations remained. It was not until July 1, 1983, in a major shift in state policy, that fees were permitted for credit cards. At the same time, legislation was enacted similar to that in Delaware to encourage out-of-state bank holding companies to establish credit card operations in Maryland.

The Maryland legislation, however, was too late to prevent four of its major banks from moving their credit operations to Delaware. The holding company of Maryland National Bank, the state's largest bank, established Maryland Bank, N.A., a Delaware subsidiary, on March 15, 1982. Maryland National Bank then moved its credit card operations to Delaware and sold all of the bank's credit card accounts to its subsidiary. By September 1982, three more Maryland bank holding companies had shifted the credit card operations of their Maryland bank subsidiaries to de novo banks in Delaware: First Omni Bank, N.A.,; Suburban Bank/Delaware;[7] and Equitable Bank of Delaware, N.A.

Pennsylvania. Early attempts to increase the interest rate ceiling on credit card loans and allow credit card fees in Pennsylvania were unsuccessful. As in Maryland the opposition was primarily from consumer groups and union organizations. Legislation was finally approved on March 25, 1982 which raised the maximum interest rate on purchases made with bank and merchant credit cards and installment contracts from 15 to 18 percent. In November 1982, banks were permitted to charge a card fee of up to $15 per year.

Opposition to an increase in interest rate ceilings and permission to charge credit card fees in Pennsylvania encouraged banks in the state to move their credit card operations to Delaware. As noted above, Mellon National Corporation through its merger with The Girard Corporation acquired the original Farmers Bank of the State of Delaware at which credit card operations were expanded.[8] Other Pennsylvania bank holding companies established FCDA banks in Delaware. PNC Financial Corporation, Pittsburgh, established PNC National Bank, Wilmington, on March 10, 1982 and CoreStates Financial Corporation, Philadelphia, parent of Philadelphia National Bank, established CoreStates Bank of Delaware, N.A., on June 1, 1982. More recently, Equibank, Pittsburgh, established Equibank (Delaware), N.A., Wilmington, on March 4, 1987.

Effects of general interstate banking

Legislation to permit out-of-state bank holding companies to acquire limited-purpose commercial banks has been followed by an accelerated trend toward general interstate banking. The activities of subsidiary banks are usually not restricted and the banks are allowed to compete fully with existing instate banks. As a result, additional alternatives are available for bank holding companies to locate operations at subsidiary banks in states where the least risk and the greatest opportunities for profit exist.

The extent to which the assets of a state's commercial banks were held by subsidiaries of out-of-state bank holding companies at the end of 1987 ranged from none in seven states to over 60 percent in five states. These were Maine, South Dakota, Washington, Delaware, and Nevada. (See Table 4.) These states also had a very high proportion of the credit card loans and the employment at commercial banks at the subsidiaries of the out-of-state bank holding companies.

Policy implications

Emphasis by states on economic development goals for the banking industry raised concerns that sufficient attention was not being directed toward any inherent safety and soundness risks associated with interstate expansions. To date the concerns do not appear to have been necessary.

Interstate expansion on the basis of deregulation in a target state may not have been the most efficient. Expansion in the home state or into other states might have been more efficient if the regulatory environments had been comparable.

The trend toward deregulation of interest rates and elimination of usury rates has accelerated. Adjacent states faced with the movement of bank operations, credit card operations in particular, to states that had eliminated interest rate ceilings on consumer loans either raised their own usury rate ceilings or eliminated them.

The trend toward interstate banking has also accelerated but the emphasis has been on

Table 4

States with over 20 percent of total domestic assets at subsidiaries of out-of-state bank holding companies

		Percent of total at subsidiaries of out-of-state bank holding companies		
Rank	State	Domestic assets	Credit card loans	Employees
1	Maine	86	93	86
2	South Dakota	76	99	62
3	Washington	73	92	70
4	Delaware	66	72	52
5	Nevada	66	98	53
6	Arizona	59	54	56
7	District of Columbia	53	48	43
8	South Carolina	48	67	41
9	Oregon	45	44	48
10	Connecticut	40	46	46
11	Montana	40	69	32
12	Idaho	37	53	36
13	Rhode Island	37	35	40
14	Georgia	35	64	33
15	North Dakota	32	47	27
16	Utah	30	17	35
17	Tennessee	30	28	29
18	Maryland	26	57	24
19	Kentucky	22	26	18
20	Florida	21	14	20
21	Indiana	21	42	22

acquisition of existing banks that offer a full range of bank services. When out-of-state bank holding companies seek to acquire existing banks, the number of possible buyers of in-state banks and generally the sale prices increase. Additionally, it also encourages bank holding companies to shift certain operations to subsidiary banks in states offering the most attractive climate for operations.

Overall results in the banking industry have been similar to those associated with financial incentives offered by states to attract industrial firms. Those states that are the first to offer new incentives to attract firms generally succeed in attracting at least a few firms. Then, faced with the prospect of their firms expanding elsewhere, other states soon begin to offer similar incentives. Once a significant number of states begin to offer similar incentives, the ability of the incentives to affect the location decision is lost.

In the case of bank deregulation, when the regulatory environment in all states becomes roughly similar, the ability of states to successfully use deregulation as an incentive for economic development is also lost.

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[1] Citicorp, New York, New York, 67 *Federal Reserve Bulletin* 181 (February 1981).

[2] J. P. Morgan & Company, Incorporated, New York, New York (Morgan Holdings Corp., Wilmington, Delaware), 67 *Federal Reserve Bulletin* 917 (December 1981).

[3] A consumer credit bank, because it does not make commercial loans, is not considered to be a bank for the purposes of the Bank Holding Company Act of 1956, as amended, and is specifically excluded from the definition of a bank in the Competitive Equality Banking Act of 1987 with given restrictions. It is therefore not subject to the Douglas Amendment restrictions on interstate banking.

[4] The Bank Holding Company Act of 1956 (BHCA), as amended, defined a commercial bank subject to regulation under BHCA as one that accepted demand deposits and made commercial loans. If both of these conditions were not present, national or state chartered banks were not subject to regulation under BHCA, and became known as nonbank banks. The Competitive Equality Banking Act of 1987 redefined the term bank to include an FDIC-insured institution whether or not it accepted demand deposits or made commercial loans. Companies that had acquired nonbank banks on or before March 5, 1987 were grandfathered and were permitted to retain the bank and not be regulated as a bank holding company but were generally restricted to existing activities and limited to an annual rate of growth in assets of seven percent.

[5] First National of Nebraska, Inc., Omaha, Nebraska, 69 *Federal Reserve Bulletin* 390 (May 1983).

[6] First Kentucky National Corporation, Louisville, Kentucky, 70 *Federal Reserve Bulletin* 434 (May 1984).

[7] Maryland National Corporation, Baltimore, Maryland, 68 *Federal Reserve Bulletin* 203 (March 1982).

[8] First Maryland Bancorp, Baltimore, Maryland, 68 *Federal Reserve Bulletin* 320 (May 1982); Sovran Financial Corporation, Norfolk, Virginia, 72 *Federal Reserve Bulletin* 276 (April 1986).