# *Fiscal Note & Local Impact Statement*

*122 nd General Assembly of Ohio*

BILL: **H.B. 201** DATE: **February 26, 1997**

STATUS: **As Introduced** SPONSOR: **Rep. Batchelder**

LOCAL IMPACT STATEMENT REQUIRED: **No — No local cost**

CONTENTS: **Allows interstate branching for state-chartered savings and loan associations and savings banks**

## *State Fiscal Highlights*

- Although it is difficult to determine the fiscal effects caused from establishing interstate branching, it appears likely at this time that the state will not be financially effected.

## *Local Fiscal Highlights*

- No direct fiscal effect on political subdivisions.

## *Detailed Fiscal Analysis*

This bill would permit state-chartered savings and loans and savings banks to branch across state lines. Likewise, it would permit out-of-state or "foreign" savings and loans and savings banks to branch into Ohio.

**Brief Review of Riegle-Neal**

On September 29, 1994, federal legislation granting financial institutions the ability to operate across state lines was signed into law. Commonly referred to as the Riegle-Neal Interstate Banking and Branching Efficiency Act, this law will have a pronounced effect on states' financial institutions. First, the legislation establishes the ability of bank holding companies (BHC) to cross state lines to conduct business. While most states already allow interstate banking, this legislation ensures that the entire nation follows a uniform set of guidelines. The second part of the Riegle-Neal legislation concerns interstate branching. Through branching, financial institutions are able to establish depository institutions in a state without having to maintain separate capital accounts and boards of directors, among other things. The federal legislation gives states the choice to either allow interstate branching for their state-chartered financial institutions or not. Either way national-chartered financial institutions will have this ability after June 1, 1997, regardless of whether states allow their financial institutions to do the same.

**Interstate Branching**

Interstate branching represents a significant change to how the financial institutions industry presently operates. Under the existing system, a bank that wants to operate in more than one state has to do so through a bank holding company. This means that a parent BHC owns separate banks in different states. Each bank has its own board of directors, regulatory structure and management team. H.B. 201 would permit a BHC and savings and loans and savings banks not presently operating under a BHC arrangement to consolidate their separate charters and form one bank.

Under Riegle-Neal, states retain certain powers. Minimum age of existence, concentration limits and taxation authority all resides primarily with the states. In addition, states retain examination authority over branches. A state bank superintendent may enter into a cooperative agreement with other state bank superintendents or maintain its role as sole examiner of interstate branching. One reason states may decide to enter into agreements would be to eliminate multiple examinations and save expenses related to conducting those examinations.

**What Other States Have Done**

States have until June 1, 1997, either to opt-in to interstate branching or to essentially prohibit this activity. As of February 1997, 43 states have chosen the former option and allowed financial institutions to branch into and out of their state. The states that have yet to act on this subject include Ohio, Arkansas, Kansas, Missouri, Montana, Nebraska and Wisconsin. The State of Texas has been the only state to opt-out of interstate branching. They have essentially taken a "wait-and-see" approach and have deferred a decision until 1999.

States that decide to opt-out of interstate branching will effectively exclude bank holding companies in their state from branching into other states and a BHC from branching into their state. If a state does not pass legislation either opting-in or out by June 1, 1997, then that state's state-chartered financial institutions will be excluded from branching across state lines. National-chartered financial institutions, though, would still be able to branch into and out of that state.

**State Effects**

*Division of Financial Institutions*

Although it is difficult to assess at this time, it is likely that the Division of Financial Institutions will not be fiscally effected by this legislation. The Division of Financial Institutions does not foresee any revenue or expenditure changes. However, the significant change in the financial institution industry that this legislation makes may result in future effects.

**Regulation/Examination**

One of the most likely areas that could be effected is regulation. Under a cooperative agreement established under the auspices of the Council of State Bank Supervisors (CSBS), Ohio has signed an agreement with Illinois, Indiana, Iowa, Michigan, Minnesota, North Dakota, South Dakota and Wisconsin for the regulation of interstate branching. This agreement essentially provides for "seamless supervision" of multi-state state-chartered institutions. The Midwest agreement, the one Ohio signed, will provide a single regulatory point at both the state and federal level. The home state (the state where an institution is located) will serve as the primary regulator for that institution and all of its branches. For example, a savings and loan located in Indiana that branches into Ohio would be examined by the Indiana Division of Financial Institutions. Although branches of this savings and loan will exist in Ohio, Ohio will permit the State of Indiana to conduct the regulatory examination. This does not mean that Ohio has relinquished all regulatory oversight. To the contrary, the Ohio Division of Financial Institutions will still retain the authority to regulate any institution in Ohio it deems necessary. The Agreement basically establishes a primary regulator (the home state regulatory body) to eliminate duplication of examinations.

Financial institutions whose principal office is located in Ohio will, likewise, encounter the same regulatory process. The Ohio Division of Financial Institutions will serve as the principal regulatory agency and examine the financial institution and all of its interstate branches. For example, a savings and loan association headquartered in Ohio that has branches in another state would be regulated by the Ohio Division of Financial Institutions. The Ohio Division of Financial Institutions would collect the regulatory fee from examining this institution. Additional expenses that may be incurred as a result of regulating a larger asset institution may also occur. However, the Division of Financial Institutions will collect a larger regulatory examination fee.

**Potential Effects of Interstate Branching**

Interstate branching has been promoted as a benefit to consumers. What effects interstate branching will likely have on consumers and what effects it will have on the financial institution industry are unclear at this time. The nation is only now beginning to examine the changes in the financial institutions industry. However, a few points concerning potential effects from establishing interstate branching can be explored in the context of this new regulatory environment.

*Increased Competition*

One of the leading benefits expected to result from interstate branching is increased competition. With easier access to state markets, many more financial institutions may consider operating branches in Ohio. The standard argument is that increased competition will create a more consumer-oriented environment. In contrast to a monopolistic scenario, increased competition is expected to enhance the financial institution industry. Consumers could benefit if this competition drives down lending rates and/or increases deposit interest rates.

*Lower Financial Institution Expenses*

Another anticipated benefit is lower expenses for financial institutions. By consolidating separate charters under one, financial institutions can realize a decrease in operating expenses. This would result since financial institutions could choose to merge into one bank with branches in different states. Financial institutions would no longer be required to maintain separate boards of directors or maintain separate management.

*Increased Diversification*

In accordance with the argument that interstate branching will increase competition is the position that it will also improve the safety and soundness of the financial institution industry. Through the ability to diversify assets and liabilities across a wider geographic area, financial institutions may realize a more stable and profitable portfolio. Because economic conditions in one state or even a region can be interdependent, interstate branching may increase the safety and soundness of financial institutions. Diversification of assets and liabilities is more likely to occur if financial institutions decide to branch into states outside of their home state region. Establishing a branch in a state with similar economic characteristics will not necessarily provide significant diversification. Therefore, the speed with which interstate branching occurs will ultimately provide a barometer for how fast diversification is advanced.

*Increase in the Number of Large Asset Institutions*

With increased competition usually comes the survival of the fittest. Those financial institutions that operate inefficiently or with low profit margins may be pushed out of the market. Interstate banking and branching may further the growth of larger, more geographically widespread institutions. Smaller institutions could be pushed out of the market. However, one argument in favor of small, community institutions has been their knowledge of the marketplace. These institutions may serve a clientele close to their institution. Because they are likely more familiar with the nuances of their marketplace, a small institution may be better positioned to assess liabilities. The institution may also be willing to borrow money to projects or individuals that other institutions may deem too risky simply because the small institution has better information. Reducing the number of community institutions, therefore, may result in tighter credit for certain companies and persons. In any case, increased competition could expand the presence of large institutions and may impact smaller ones.

**How Interstate Branching Relates to the Proposed Bank Tax Change**

Very germane to the issue of interstate branching is the executive's proposed change in bank taxation. Due to the advent of interstate branching on June 1, 1997, with or without state legislation, many Ohio-based banks have indicated that they will leave the state if the bank tax rate is not changed. Interstate branching has essentially spurned the motivation to change Ohio's bank tax rates.

With the passage of the Riegle-Neal federal legislation, banks no longer have to be chartered in every state where they do business. Banks will be able to consolidate their separate charters and form one bank, from the regulatory and taxation standpoint. Existing Ohio tax law would create a peculiar “all or nothing” tax situation under interstate branching. For example, banks chartered in other states would avoid paying Ohio taxes since they would be regulated by their home state. Ohio would get little or no revenue from out-of-state banks. Examination and regulatory fees would be paid to the home state regulatory agency. In similar circumstances, Ohio state-chartered banks that operate interstate branches would be taxed on their activity in Ohio as well as other states. These Ohio-based banks would be regulated by the Ohio Division of Financial Institutions and assessed fees based upon the amount of their assets, which includes branch assets.

The executive's proposal does four major things:

1. Adopts Multi-state Tax Commission (MTC) recommendations on apportioning the business income of financial institutions.
2. Reduces the tax rate on financial institutions from the current 15 mills to 14 mills in 1999, and to 13 mills in tax year 2000.
3. Extends the tax to banks issuing credit cards, making loans, and performing other financial services, but which do not take deposits in the state.

These companies were formerly not subject to the financial institutions section of the corporate tax in Ohio. If they paid any corporate tax (the issue here is *nexus*), it was under the general corporate provisions and was probably small. The rate cut also brings bank taxation more into line with competitors who are classified as “dealers in intangible property” and pay a tax of only 8 mills on net worth.

4. Creates an alternative apportionment formula (with the option of various modifications) for the next four years so that the tax structure will not disadvantage a financial institution that consolidates its headquarters' operations in Ohio and operates branches in other states.

At this point, LBO does not have an estimate for provisions 1, 3, and 4. The Tax Department believes them to be revenue neutral. This is particularly the case regarding the first provision. Since many states are currently moving to adopt the Multi-state Tax Commission recommendations in light of Riegle-Neal, the incentive for banks to relocate headquarters should be greatly reduced. LBO does estimate a loss from provision 2 of approximately $15.2 million in FY 1999, and $30.4 million in FY 2000 and annually thereafter.

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