Delaware Moves Toward Interstate Banking: A Look at The FCDA

by Janice M. Moulton1

When Delaware passed the Financial Center Development Act (FCDA) in February, 1981, this legislation was hailed by some in the financial press as a dramatic move toward interstate banking. Delaware was cited as one of the first states to welcome out-of-state banks and to attract new investments in financial services. This decision to attract major banking firms to Delaware also was viewed as part of a concerted effort by the governor, the legislature, and the business community to broaden the state's economic base.

Banks have now had time to respond to the FCDA. Because of the capitalization and entry requirements, the FCDA provisions have appeared most attractive to a fairly select group of large bank holding companies, many of whom have already made their move. They have established operations in Delaware ranging from credit-card services, to cash management, to wholesale lending. The home-state Delaware banks, which originally supported the bill because it restricted potential competitors, appear to have received enough benefits during the past two years to continue their support. In light of these responses to the FCDA, Delaware's state legislature is attempting to build on this positive momentum with other similar legislative initiatives.

While the thrust of the FCDA package is consistent with interstate banking legislation in some other states, the FCDA imposes certain entry conditions and emphasizes economic gains to Delaware. Other states are developing their own strategies to compete for segments of the financial services business. Some states have laws similar to Delaware's, while others, such as Massachusetts, have favored a regional approach to interstate

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1Research Officer and Economist in the Research Department of the Federal Reserve Bank of Philadelphia, where she heads the Banking and Financial Markets Section. The author wishes to thank Eleanor Craig, Associate Professor of Economics at the University of Delaware, and Chair of the Delaware Economic and Financial Advisory Council, for helpful comments and suggestions.
banking. If this trend continues, such diversity among the different states will lead to a patchwork quilt pattern of legislation on interstate banking. Whether this evolution reflects a desirable financial structure for the nation is up for debate.

**FCDA: What Are the Major Provisions?**

There are four major provisions in the FCDA. The first provision invites out-of-state bank holding companies to enter Delaware, and the other three — which liberalize credit terms, eliminate usury limits, and restructure bank taxes — supply the incentives for them to do so. The most important provision of the FCDA allows an out-of-state bank holding company or its subsidiary to acquire a single newly established bank in Delaware. The Douglas Amendment to the Bank Holding Company Act of 1956 prohibits a bank holding company from acquiring more than 5 percent of the voting shares of a bank's stock in another state unless that state specifically permits such a purchase. Delaware has acted under the Douglas amendment and was the second state — after South Dakota — to invite this type of entry.1

Under the FCDA, an out-of-state bank holding company can hold all or nearly all of the voting shares of the Delaware bank, provided several conditions are met. Unlike home-state Delaware banks that can branch anywhere in the state, out-of-state banks are limited to a single office.2 This office must be operated "in a manner and at a location that is not likely to attract customers from the general public...to the substantial detriment of existing banking institutions located in this State" (Section 803d). When the new Delaware bank opens, it must have $15 million or more in capitalization; by the end of its first year of operation, the bank must have at least $25 million in capitalization and employ at least 100 people. Further, each application must be approved in advance by the Delaware Bank Commissioner, who has the power to order divestiture of the stock held by the out-of-state bank holding company if these conditions are not met. Hence, the newly chartered state or national bank faces operational restraints on branching and on its competitive posture; in effect, it is a limited-purpose subsidiary.

Other provisions of the FCDA create incentives for outsiders to enter Delaware to avoid restrictions elsewhere. Unlike legislation in most other states, the FCDA allows borrowers and lenders to negotiate credit terms for both consumer and commercial lending without regulatory interference, except for some aspects relating to individual borrowers. The act also permits banks to impose several types of fees and other charges for revolving or closed-end credit, as long as the contract specifies these charges.3

The FCDA also liberalized the credit rules by eliminating usury ceilings on most types of loans. Various sections in the act remove interest rate ceilings on automobile loans, secondary mortgages, small loans, and retail installment loans. These free conditions apply whether the lender is a bank, finance company, retailer, or other installment lender.

Favorable tax rates for banks are probably the biggest incentive in the FCDA package. Banks are taxed on a sliding regressive scale; that is, the tax rate falls as the bank's income rises. The tax rate is 8.7 percent for the first $20 million of net income, 6.7 percent on net income from $20 to $25 million, 4.7 percent on net income from $25 to $30 million, and 2.7 percent on net income over $30 million. Since all the Delaware home-state banks currently have net incomes less than $20 million, they will not benefit directly from the lower tax rates until they reach a larger size. But for larger out-of-state banks facing high state and local taxes in their

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1The other major piece of federal interstate banking legislation is the MOFCB Act. As amended by the Banking Act of 1935, MOFCB allows national banks to branch statewide if permitted by state regulation. Thus, if effectively prohibits national banks and state member banks from branching across state lines.

2In Delaware, a bank is defined as a Delaware state-chartered bank or a national bank, and not as an institution which takes demand deposits and makes commercial loans.

3Such items include membership fees, connection fees, refinancing fees, late fees, reasonable attorneys' fees, front-end charges, and collection costs upon default. Lenders also can make variable rate loans and can raise the interest rate on revolving credit as long as the contract so provides. However, consumer safeguards require that individual borrowers be given advance written notice of any increase in rates. Moreover, borrowers who prepay a consumer loan in full must have an unearned interest refunded to them and face no prepayment charge.
home-office locations, these rates build in a strong incentive to move to Delaware.
In summary, the FCDA invites out-of-state bank holding companies to set up limited-purpose subsidiaries in Delaware, and it provides ample inducements in the form of unregulated credit terms and lower taxes for them to do so.

WHY THE FCDA?
Delaware saw an opportunity to provide fertile ground for producing banking services and wanted to co-opt a leadership position before the federal government or other states revised their laws. The state had both the means (via an advisory task force) to generate new proposals, and the responsiveness (via Governor du Pont and the General Assembly) to follow through on them.

Delaware could have picked any one of a number of industries in order to diversify its economic base, but decided to go for banking. Why? The main reason is the nature of the banking industry. Banking is regulated heavily at the federal and state level, but these regulations can be modified in many ways by the states to create profitable opportunities for banks. Delaware’s FCDA utilizes powers given to the states under the Douglas Amendment, which authorizes a state to lift the general federal prohibition against in-state bank acquisitions by out-of-state bank holding companies. Delaware’s action places it among a small group of states leading the others in deregulating price, product, and geographic constraints in banking.

Delaware is no newcomer to the business of attracting business. For many years, for example, Delaware’s liberal incorporation law has made it the enfranchisement capital of the U.S. This businesslike approach to economic growth gained new life when Governor du Pont mobilized an economic development effort in the state shortly after he took office in 1977. As part of this overall effort, he established an advisory task force of business and government leaders to plan the strategies to achieve economic growth. The state recognized the need to broaden the employment base beyond autos and chemicals, the two major industries. Specifically, the state needed to diversify its industry to build a stronger economic base to create new jobs and to generate revenues for the state’s treasury.

About the same time that policymakers in Delaware were looking for a new vehicle to spur their development effort, the Supreme Court made a ruling that had the potential to affect the banking industry significantly. In the 1978 Marquette decision, the Supreme Court ruled that banks with nationwide credit-card operations could charge the rates and fees established in their home state to their customers anywhere in the country. The big New York banks had been chafing under that state’s usury laws, claiming that the state’s interest rate ceilings and the high interest rate environment were imposing large losses on their credit card operations. Citicorp led the New York banks in their search for a more hospitable state that would let them take advantage of the court ruling. South Dakota obliged by inviting Citicorp to set up its credit card operations there, and eliminated the state’s limits on interest rates and fees as well. Other New York banks, particularly Chase and J.P. Morgan, shopped closer to home and found Delaware to have a receptive business climate. The aims of the New York banks meshed nicely with the goals of the advisory groups and the development effort. Close consultation followed between the banks and the state as Delaware turned its effort toward developing the FCDA.

In attempting to make Delaware a financial center, the lawmakers hoped to pattern Delaware after Luxembourg, a relatively open and unregulated banking city in Europe. The elimination of usury ceilings and greater allowable fees are consistent with an unfettered financial system. However, the invitation to enter Delaware is not wide open; the FCDA’s conditions for entry lift the interstate barrier only part way. Indeed, the conditions specifying de novo entry, location, employment, and capitalization are quite restrictive. In essence, Delaware is setting up new regulations to its own particular advantage. Some of the conditions serve to further the state’s interest by increasing employment and investment in Delaware. Other conditions helped to gain the support of the in-state banks for the legislation. For example, the Delaware banks, wary of their big New York neighbors, wanted their retail deposits

and consumer loans protected from competition. When outsiders were prohibited from soliciting public deposits, the Delaware banks supported the FDCA, they hoped they would benefit from the growth in economic activity and the new demands for financial services.

The FDCA was an innovative attempt to use regulatory and tax policies to attract an important segment of the banking industry to Delaware. A number of out-of-state institutions have responded to these incentives. While the effects of Delaware's FDCA on neighboring states are difficult to gauge, some are losing business, actual or potential, while Delaware gains.

HOW IS THE FDCA FARING?
The net effect of the FDCA has been to promote certain types of operations in Delaware by large banks. These banks are big enough to reap considerable benefits from the lower tax rates, and they are not deterred by the FDCA's capitalization and employment requirements.

Since the FDCA was passed in February, 1981, eleven major bank holding companies have opened subsidiaries in Delaware. They include the five largest New York banks, two from Pennsylvania, and four from Maryland. To date, the new subsidiaries employ about 1,200 people and, as they expand their operations, are likely to have many more on their payrolls by the end of 1983. Morgan Bank Delaware, a subsidiary of J. P. Morgan & Co., was the first out-of-state bank to open its doors in Delaware in December 1981. Since that time, its assets have grown to over $1.8 billion and its capital to more than $316 million. Moreover, Morgan Bank Delaware's profits already exceed $20 million, allowing them to enter the regressive tax structure.

Morgan's operations focus on corporate and large institutional customers. Like Morgan, several of the other banks also are engaging in wholesale banking activities, such as making large commercial loans and providing cash management services to corporate and institutional clients. Several banks initially emphasized credit card processing and now have substantial credit card operations.

As long as the out-of-state banks stick to wholesale banking and credit card operations, the home-state banks are not likely to see their retail banking operations threatened. The four largest home-state commercial banks and one mutual savings bank are not heavily oriented toward commercial lending. They focus principally on retail banking and they actively compete in the retail market for mortgage operations, consumer loans, and trust funds, for example. The restrictions built into the FDCA against soliciting deposits and retail business appear to be working. The Delaware banks do have some complaints about the FDCA, however. They claim to have experienced some loss of personnel and have had to adjust their salary structure upward in response to the new competition by the out-of-state banks. But on the plus side, the home-state banks say they are servicing the retail needs of the new employees. In addition, the out-of-state banks have boosted total economic activity, such as the construction of commercial office space. Thus far, the Delaware banks contend that the pluses of the FDCA outweigh the minuses.

The FDCA provisions may be less attractive in the future, however, because the usury and tax advantages of Delaware may erode over time as other states develop their own incentive packages. Pennsylvania, for example, passed laws in 1982 permitting annual credit-card fees up to $15 and raising the interest rate that banks can charge on their credit-card operations from 15 to 18 percent. New Jersey raised its interest rate ceiling on several types of loans, and Maryland just passed a law deregulating credit terms. As long as this competition in usury and tax incentives continues, banks will shop around for the best deal.

Thus, the FDCA has been successful in attracting subsidiaries of large out-of-state banking holding companies while at the same time protecting the retail turf of the home-state banks. This financial sector expansion may be limited, however, not only by FDCA operational constraints, but also by the development of attractive deregulatory packages in other states.

INTERSTATE BANKING LAWS AND OTHER STATES DIFFER FROM FDCA
Delaware is not alone in perceiving that states can gain economically by formulating their own

FEDERAL RESERVE BANK OF PHILADELPHIA
<table>
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<tr>
<th>Parent Bank Holding Company</th>
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<th>Type of Business</th>
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<tr>
<td>J. P. Morgan &amp; Co., Inc.</td>
<td>Morgan Bank Delaware (12/21/81)</td>
<td>Wholesale banking</td>
<td>$1,833 126</td>
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<td>Chase Manhattan Corp.</td>
<td>Chase Manhattan Bank (USA), N.A. (2/11/82)</td>
<td>Consumer lending on a national basis</td>
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<td>Chemical New York Corp.</td>
<td>Chemical Bank (Delaware) (10/1/82)</td>
<td>Wholesale and commercial lending</td>
<td>857 68</td>
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<td>Citicorp</td>
<td>Citibank (Delaware) (10/6/82)</td>
<td>Full range of cash management services to institutional customers nationally</td>
<td>54 35</td>
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<tr>
<td>manufacturers Hanover Corp.</td>
<td>manufacturers Hanover Bank (Delaware) (1/3/83)</td>
<td>Wholesale commercial banking and trust business, domestic and international</td>
<td>231 40</td>
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<td>Bank of New York Co., Inc.a</td>
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<td>100 23</td>
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<td>E. F. Huttonb</td>
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<td>Maryland National Corp.</td>
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<td>First Maryland Bancorp</td>
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<td>Equitable Bancorp.</td>
<td>Equitable Bank of Delaware, N.A. (6/11/82)</td>
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<td>Suburban Bancorp</td>
<td>Suburban Bank, Delaware (9/15/82)</td>
<td>Retail banking and consumer credit operations</td>
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<tr>
<td>PNC Financial Corp.</td>
<td>Provident of Delaware Bank (3/10/82)</td>
<td>Investors' services, wholesale and consumer lending, international business</td>
<td>202 97</td>
</tr>
<tr>
<td>Philadelphia National Corp.</td>
<td>Philadelphia Bank (Delaware) (6/1/84)</td>
<td>Credit card services</td>
<td>166 113</td>
</tr>
<tr>
<td>Mellon National Corp.c</td>
<td>Girard Bank Delaware (12/20/81)</td>
<td>Full range of services</td>
<td>401 492</td>
</tr>
</tbody>
</table>

a They plan to begin operations with 25 employees and to expand to 125 within one year.
b Special legislation enabled E. F. Hutton, an investment banking firm, to set up a subsidiary that is exempt from FCDA requirements.
c Special legislation enabled Girard Company to acquire the troubled, state-assisted Farmers Bank.
Several other states have passed laws permitting out-of-state bank holding companies to enter. These laws appear to take three general forms. [See SUMMARY OF STATE LAWS ON INTERSTATE BANKING] The first type sets conditions for entry, such as Delaware's and South Dakota's requirement that an out-of-state subsidiary operate in a manner not likely to attract customers from the local public. Other states,

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<th>SUMMARY OF STATE LAWS ON INTERSTATE BANKING</th>
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<td><strong>Limited Purpose Laws</strong></td>
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<tr>
<td>South Dakota: Permits out-of-state bank holding companies to establish a single office bank, subject to capitalization requirements and restrictions on attracting customers from existing banks. Also permits out-of-state bank holding companies to acquire a single in-state bank. Provided the acquiring bank does not then expand its retail operations in the state.</td>
</tr>
<tr>
<td>Delaware: Permits out-of-state bank holding companies to establish a single office bank, provided the bank is oriented towards wholesale operations and meets certain capitalization and employment restrictions.</td>
</tr>
<tr>
<td>Virginia: As of July 1, 1983, permits out-of-state bank holding companies to set up a single office credit card subsidiary, subject to capitalization and employment restrictions.</td>
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<tr>
<td>Maryland: As of July 1, 1983, permits out-of-state bank holding companies to establish a single office bank, subject to capitalization and employment requirements and restrictions on attracting local customers from existing banks.</td>
</tr>
<tr>
<td>Nebraska: As of August 26, 1983, permits out-of-state bank holding companies to set up a single office credit card subsidiary, subject to capitalization and employment restrictions.</td>
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<tr>
<td><strong>Grandfather Laws</strong></td>
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<tr>
<td>Iowa: Permits out-of-state bank holding company whose operations were grandfathered—that is, the bank holding company was registered with the Fed on January 1, 1971 and owned two or more in-state banks—to acquire other in-state banks, so long as all banks controlled by the holding company have 8 percent, or less of total state deposits.</td>
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<tr>
<td>Florida: Permits three out-of-state bank holding companies, two U.S., and one Canadian, whose operations were grandfathered as of December 20, 1972, to acquire other in-state banks and thrift companies.</td>
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<tr>
<td>Illinois: Permits one out-of-state bank holding company, whose operations were grandfathered as of December 31, 1981, to acquire other in-state banks.</td>
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<tr>
<td><strong>Reciprocity Laws</strong></td>
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<tr>
<td>Maine: Permits out-of-state financial institution companies to acquire in-state financial institutions on a reciprocal basis, that is, provided the other state allows its own financial institutions to be acquired under no more restrictive conditions.</td>
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<tr>
<td>New York: Permits out-of-state bank holding companies to acquire in-state banks on a reciprocal basis, provided the other state has enabling legislation.</td>
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<tr>
<td>Massachusetts: Permits depository institution holding companies located in other New England states to acquire Massachusetts depository institutions on a reciprocal basis. Also permits branching on a reciprocal basis.</td>
</tr>
<tr>
<td>Connecticut: As of June 8, 1983, permits depository institution holding companies located in other New England states to acquire Connecticut depository institutions on a reciprocal basis.</td>
</tr>
<tr>
<td><strong>Unrestricted Laws</strong></td>
</tr>
<tr>
<td>Alaska: Permits out-of-state bank holding companies to acquire, with few restrictions, in-state banks that were founded three or more years ago.</td>
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</tbody>
</table>
such as Florida and Iowa, also fall into this condi-
tional category because of their grandfather clauses. 
These clauses restrict acquisitions to particular 
out-of-state institutions which operate a 
certain kind of bank in the state. In other words, 
these states have attached conditions which dis-
criminate among potential entrants, reflecting the 
degree to which the state wants out-of-state bank 
holding companies to enter. 

The so-called reciprocal banking laws of Maine, 
New York, and Massachusetts represent the second 
general type of interstate banking law. These states 
allow out-of-state bank holding companies to 
acquire full-service banks within the state, 
provided that the home state of the acquiring 
holding company permits similar acquisitions. 7 
Massachusetts is more restrictive than others since 
its reciprocity provisions apply only to holding 
companies in the other New England states. 

The third type is represented by only one state at 
the moment, Alaska, which allows out-of-state 
bank holding companies to acquire full-service 
banks in the state without any reciprocity condi-
tions. The main limitation is that an in-state bank 
must be in operation for at least three years before 
it can be acquired. 

These various interstate banking laws illustrate the 
diverse approaches that states are using to 
attract business in financial services. A few years 
ago, the banking community anticipated a regional 
pattern of the relaxation of banking laws. It was 
thought that states located near each other and 
having strong economic ties would join together 
to form an extended banking area, and that as 
these banking regions formed, they would gradu-
ally merge into one nationwide banking market. 8 

7Massachusetts’ law deals with depository institutions or 
their holding companies and not just banks. It also permits 
interstate branching acquisitions in other New England states 
on a reciprocity basis. 

8The New England states currently are attempting to establish a 
regional banking area with reciprocal legislation (although the 
proposed reciprocity provisions differ on the part of the indi-
vidual states) Such an agreement to exclude all but the New 
England states may raise constitutional issues. Specifically, 
the Compact Clause limits the ability of states to enter into 
agreements which might encroach upon the political sovereignty 
of the federal government. For this reason, the New England 
states are seeking Congressional approval for their agreement. 

For further discussion, see John D. Hawke, Jr., “Are State
Indeed, the most recent major piece of federal 
banking legislation, the Gann-St. Germain bill, has 
a regional emphasis where mergers are concerned. 
It authorizes “extraordinary acquisitions” of failing 
institutions on a stepwise basis—first, institutions 
of the same type in-state, then those in adjoining 
states, and then those in states still further away. 
However, a regional approach to geographic deregula-
tion may be overwhelmed by the tremendous 
strides bank holding companies and non-banks 
have already taken toward nationwide operations. 
Financial institutions, both banks and non-banks, 
have become fiercely competitive in financial 
services, and many of these services now have 
national markets. Developing technology in com-
munications and electronic banking has spurred the 
movement toward broader markets. 9 

These various maneuvers by the states and by 
financial institutions suggest that the interim 
deregulatory process will likely be far from an 
ordeal. One both advantages and disadvantages 
mark the current trend toward a patchwork quilt 
pattern of state laws regulating interstate banking. 
Banking organizations gain because geographic 
deregulation enables them to exploit profitable 
opportunities by “voting with their feet.” Advantages 
come to the consumer, too, in the form of 
increased financial services, lower prices, and 
increased demand for labor services. The states, 
like Delaware, which pass interstate banking laws, 
also stand to gain. States have the advantage of 
formulating their own laws. In addition, if the scope 
of operations is sufficiently large, entry by out-of-
state institutions may boost other sectors of a 
state’s economy, and such a gain will likely gener-
ate new tax revenues for the state’s treasury as 
well. 

At the same time, there are several disadvantages 
to the current modus operandi of “each state for 
its benefit.” Planning is complicated both for banks and
for states because the environment is so uncertain. Banks must assess the merits of a given location without knowing whether another state will soon offer regulations that look more attractive from a profit standpoint. Economic development efforts by particular states may suffer setbacks if other states offer "greener pastures." As competition across states sharpens (South Dakota is on a second round of legislation), segments of the banking industry could end up moving from one state to another in response to the "best offer," so to speak; the result, however, may be little improvement in the overall volume of services provided to society. Individuals, too, could suffer from dislocations in the markets for labor and rental space as financial institutions move from state to state. Finally, consumers get only partial gains from many state deregulation efforts since factors such as Delaware's employment, capitalization, and location entry requirements tend to limit the services offered to consumers.

For many years, the advantages of maintaining the status quo in interstate banking legislation have outweighed the disadvantages in national political circles. But the increasing number of interstate banking laws passed by states like Delaware, and the growing willingness of bank holding companies and non-banks to cross state lines, may have tipped the balance in the other direction.10 Indeed, many economic analysts argue that it is time now to allow for a more orderly transition to interstate banking. They also argue that one reason why state actions on interstate banking are so important is that the federal government is pressured to act in this area.

When the federal government finally does act, the best interests of the nation as a whole may dictate an interstate banking law different from that chosen by Delaware or most other states. For example, if competition gets high weight in federal legislation, a less restrictive law than Delaware's may be the prototype for the nation. In the meantime, however, numerous states are moving ahead with legislation similar to Delaware's. And Delaware appears quite successful with its conditional type law.

**WHAT DOES THE FUTURE HOLD FOR BANKING IN DELAWARE?**

Delaware's FCDA has largely fulfilled its promise of building an expanded financial industry in the state. Perhaps five or ten more large out-of-state bank holding companies will set up operations in Delaware to take advantage of the FCDA. Beyond that, banking's future in Delaware depends very much upon Delaware's present economic condition and the opportunities available in the changing financial sector.11 Certainly the FCDA has allowed Delaware to position itself well for future changes in interstate regulation; further initiatives will depend upon whether the state's policymakers are able to build on the gains made by FCDA. With the rapid changes occurring in the financial services industry, Delaware can hardly afford to restrict itself to a maintenance effort on the FCDA—not if Delaware wants to stay in the forefront of interstate banking. Some possibilities for new legislation include expansion of the international banking

10 In recent testimony before Congress, Fed Chairman Volcker addressed the implications of state actions which are motivated by a "desire to compete for jobs rather than careful consideration of a desirable evolution of the financial structure for the nation." He stated that federal concern in this area is motivated by the federal support that depository institutions, including those that are state-chartered, receive in the form of deposit insurance and access to the discount window. Under the Bank Holding Company Act, the Fed has traditionally maintained a policy permitting state-chartered depository institutions to engage in any activities allowed under state charter. But now, in many states, state-chartered banks or chartered banks can engage in a "much wider range of financial and nonfinancial activities" than federally-chartered banks or chartered banks. Volcker suggested that such divergences between federal and state treatment have become large enough to require Congressional review and debate. Further, he proposed that Congress address the issue of "whether it is properly a federal prerogative to establish the outer bounds within which the dual banking system may continue to be a useful and constructive force." See the American Banker, May 5 and 6, 1983 for a reprint of Volcker's testimony.

11 One critical group that will help determine whether Delaware can build on the success of the FCDA is the Delaware Development Office. Established after the FCDA was passed in 1981, the Development Office encourages the expansion of existing industry and promotes new business for the state. Thus far, this office has been instrumental in maintaining contact with the home-state banks and in assisting the out-of-state banks with their plans. The office also works closely with firms to determine their employment needs and even to design training programs. When other legislation follows the FCDA the role of the Development Office could be crucial.
sector, the creation of consumer credit banks, or allowing expanded bank entry into insurance, real estate, investment companies, and other activities. Whatever comes next, both policymakers and bankers are sure to find their opportunities challenging.

1 Delaware recently passed two expanded powers bills, "The Consumer Credit Bank Act," and "The International Banking Act."