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STATEMENT

by

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

on

S. 72

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Mr. Chairman, I am pleased to appear before this Committee on behalf of the Board of Governors to testify on S. 72, the Competition in Banking Act of 1977. This bill would have far reaching implications for the regulation of banking structure in the United States. It affects not only the standards and administrative procedures employed by the Federal banking agencies in acting on proposed bank mergers but also those applied by the Board of Governors in reviewing proposed new activities for bank holding companies and deciding on particular acquisitions. Before addressing the major substantive provisions in the bill, I believe that it is important to comment briefly on the four basic findings and purposes of the bill which presumably provide the rationale for many of its specific provisions.

The bill's first finding is that there has been a continuing trend toward concentration of banking resources in the United States. However, recent Board studies fail to indicate that there has been a significant trend toward increased concentration of domestic banking resources nationally, statewide, or in most of the country's 400 most significant local banking markets. In fact, concentration appears to be declining.

For example, at the national level between 1968 and mid-1977, the 10 largest banking organizations' share of domestic deposits declined from 20.4 per cent to 18.3 per cent and the top 25's share dropped from 31.9 per cent to 28.0 per cent. The 100 largest organizations' share declined from 49.7 per cent to 45.0 per cent over this period. A similar pattern is found at the statewide level. Moreover, it is important to note that the most concentrated states -- all of which permitted statewide branching -- typically had declines in concentration. (See attached tablė). The results of our review of over 400 local markets, including 213 SMSAs, between 1966 and 1975, indicate that the majority tended to become less concentrated and to exhibit a more competitive structure irrespective of the measures used. We also note that even these figures tend to overstate concentration since they do not reflect the rapid growth of bank type activities at savings and loans, mutual savings banks and credit unions. In many states, thrift institutions now provide substantial competition for commercial banks.

The sharpest growth in our largest banking organizations has been in the foreign sector; and it is only when deposits held abroad are included that there appears to be an increase in banking concentration. While it might be argued that foreign financial activities of U.S. banks contribute to their overall economic power, this argument is not particularly germane to the proposed bill which focuses on domestic and not worldwide concentration and competition.

The second finding of the bill points to the fact that an increasing portion of the Nation's banking resources have come under bank holding company control. The registered bank holding company share of domestic U.S. deposits did increase from 16 per cent in 1970 to 70.8 per cent in 1977 but about two-thirds of this increase resulted from the inclusion of over 1,100 one bank holding companies under the umbrella of the Act in 1971. This includes 16 of the Nation's 25 largest banks. Also, it is important to note that while bank holding companies account for 70.8 per cent of domestic bank deposits, all but about 8 per cent of these deposits are in the lead banks of holding companies. Thus, expansion of bank holding companies' share of deposits has been due principally to conversion in the legal status of existing banking organizations to the holding company form and not to acquisitions of existing banks by multi-bank holding companies.

A third finding of the bill is that bank holding companies have expanded into activities beyond those directly related to banking. Specific activities cited are: insurance agency and underwriting services, leasing, accounting, travel, and courier services; management and data processing services; and marketing securities. While these descriptions do not comport with the list of permissible activities issued by the Board, several points are worth noting with respect to this general finding.

In administering Section 4(c) (8), the Board has generally determined various activities to be "closely related" to banking if they satisfied one or more of the following four criteria:

(1) The activity was one in which a significant number of banks have engaged in for some years (e.g., trust services);

(2) The activity involves either the acceptance of deposits or lending (e.g., consumer finance companies);

(3) The activity is complementary to the provision of a banking service (e.g., acting as an insurance agent for credit related policies);

(4) The activity is one in which banks possess considerable expertise (e.g., data processing for banks).

So far, the Board has only approved 17 activities as being permissible for bank holding companies -- 12 by rulemaking and 5 by order. An additional 11 were denied, including travel agencies (mistakenly mentioned above in the findings of the bill as an approved activity) as well as property management, real estate brokerage and operating a savings and loan association. Generally, activities approved, except underwriting of credit life insurance, were, in fact, permissible activities for national banks or their subsidiaries at the time they were authorized. Moreover, the Board did not provide for _carte blanche_ entry into those activities as is implied by the findings of the bill. In many cases, the activities were severely restricted to those that are bank or finance related and, in some instances, such services may only be provided to a customer in connection with a bank related service (such as the sale of credit life insurance).

Furthermore, by far the largest number of bank holding company expansions in the nonbank area have been _de novo_ and not by acquisition; over 3,100 _de novo_ nonbank notifications were received between January 1971-September 10, 1977 as compared with only 461 acquisitions of existing firms approved by the Board; 54 applications were denied.

Finally, despite the number of acquisitions acted upon by the Board and de novo notifications received, nonbanking assets still account for less than 4 per cent of bank holding company assets. In view of these considerations, we question whether this finding of the bill describes a development of any real significance to the economy.

The fourth finding is that credit resources of the Nation have been misallocated by bank holding companies. The basis of this finding is not stated and is unclear. Objectively, there appear to be several reasons why bank holding companies might be expected to facilitate a more efficient allocation of credit. Bank holding company expansion in restrictive branching states, together with the provision of various bank type lending services on an interstate basis through nonbank affiliates, probably has resulted in increased competition in local and regional markets and has facilitated inter-regional credit flows. Both could be expected to provide more rapid and efficient allocation of loan funds geographically. Similarly, the ability to attract funds from cheaper sources through the debt and equity markets, particularly during periods of tight money, may have moderated financing pressures on holding company banks and helped maintain their ability to accomodate credit demands.

The causal factors cited in the bill for such misallocation of resources are that the Federal Reserve has not adequately protected the public interest in approving activities in which bank holding companies could engage and has not maintained continued oversight over the activities of bank holding companies in a manner which protects the public interest. In my view, the facts would not support either finding. A review of Board orders issued in connection with action on applications clearly demonstrates that all statutory factors, i.e., competition, convenience and needs of the public, and financial and managerial resources, are carefully weighed. In the area of public benefits, the Board has taken definitive action such as obtaining commitments for reduced rates on reinsurance activities. With respect to financial considerations, the Board has long held to the philosophy that bank holding companies should serve as a source of strength for their subsidiary banks. In many instances, the Board has obtained commitments from holding companies to supply additional capital to their subsidiary banks and has urged that nonbank subsidiaries be adequately capitalized. In 1974, when certain banking firms began to experience sharp increases in problem loan situations, the Board instituted a go-slow policy with respect to further expansion. Consistent with this policy, the Board has denied a number of applications, some for the Nation's largest banking organizations.

Since 1970, the Board has taken a number of steps to improve its ongoing surveillance and supervision of bank holding companies. For example, as a supplement to its other surveillance activities, the Board recently announced a new inspection program whereby most large bank holding companies will be subject to an on-site inspection annually. The Board also collects detailed information on intra-holding company transactions which are routinely monitored. Additionally, recent changes in the reporting forms for banks have been instituted and special emphasis is being placed on the analysis of foreign operations and risk exposure of large organizations.

As my comments suggest, our review of the facts reveals little in the way of evidence or analytical support for the bill's four principal findings. This gives rise to a general conclusion on the part of the Board that the actual adverse effects, which the bill seeks to redress, are small. The Board feels that restrictions should not be imposed nor regulation intensified without demonstrated need, especially when the longer run effects may be to inhibit competition, or to protect existing firms from competitive forces. At the same time, we also recognize that there may be some specific areas affecting the Federal regulation of bank and bank holding company structure which need review and the Board would support Committee efforts in these areas. I shall now turn to the major substantive features of the bill and our reactions to them.

The proposed legislation would establish an outright prohibition of any bank merger or holding company acquisition of a bank in which the resulting company would control more than 20 per cent of the banking assets in any state. The one exception would be where the proposed acquisition is necessary in order to prevent a bank failure and no less anticompetitive alternative is available. The Board questions the desirability of such an absolute limit, especially in view of the wide differences in bank structures in the various states and the lack of evidence that there has been a trend towards concentration of resources at the statewide level. We are particularly concerned that such a limitation would have the anticompetitive effect of protecting some banks from actual competition or the threat of future competition that could result from relatively modest additional acquisitions by large banking organizations. Undoubtedly, the effect of the instant legislation would also be to significantly inhibit the growth of some banking organizations by even the de novo route. The Board believes that there are few instances when such expansion would not be procompetitive and to restrict de novo expansion would not be in the public interest.

The proposed percentage limitation, as drafted in terms of total assets, would also discriminate against those institutions which derive a significant portion of their business assets from the national and international markets. These institutions' domestic expansion by acquisition within a state would be curtailed even through they might hold a significantly smaller proportion of the business originating within the state than other smaller institutions. The focus on bank assets also overlooks the fact that expanded powers of nonbank financial intermediaries, such as thrift institutions, are blurring the distinction between banks and these other institutions and are increasing competition in the markets for some banking services.

Should the Congress choose to adopt such a percentage limitation, the Board believes that it should be based on domestic resources. However, because of the uniqueness of each state, the Board strongly feels that no single percentage figure would be appropriate. Use of a single figure would ignore important factors such as (a) the number and powers of competing institutions operating in each state, (b) their size distribution, (c) the general economic environment in each state and (d) restriction on branching and geographical expansion. Federal imposition of an overall constraint would interfere with the right of a state to decide what type of structure best meets its needs. The Board feels that the present case-by-case approach better serves the public interest, since it provides the Board the needed flexibility to weigh the unique competitive, structural and other important factors associated with a given state.

Despite concern for the bill's asset limitation, which the Board opposes, there are several other provisions pertaining to bank mergers and holding company acquisitions of banks which provide useful clarifications of existing law. In particular, the Board favors those provisions which permit denial of acquisitions even when the level of the possible anticompetitive effects does not constitute violation of the antitrust laws or the 20 per cent limitation, if the responsible agency believes that the proposed acquisition would not be in the public interest and the anti competitive effects are not clearly outweighed by the probable consequences for community convenience and needs. This feature has the desirable effect of clarifying that competitive considerations should dominate the banking agencies' decisions on proposed acquisitions.

As currently drafted, S. 72 would result in major changes in Section 4(c)(8) of the Bank Holding Company Act, which governs the nonbanking activities of holding companies. At present, bank holding company proposals to engage in nonbanking activities must pass two tests -- the "closely related" test and the "public benefits" test. S. 72 would make both tests more stringent.

The "closely related" test now contained in Section 4(c)(8) requires that a proposed activity be "so closely related to banking or managing or controlling banks as to be a proper incident thereto." In contrast, S. 72 would require that a proposed activity be "so closely <u>and directly</u> related to banking or managing or controlling banks as to be a proper <u>and</u> <u>necessary</u> incident thereto." It is not clear what these additions would mean for the "closely related" test. One possibility is that it would limit permissible 4(c)(8) activities to "banking activities", that is, activities in which banks themselves generally can engage. If so, the existing list of permissible activities would not be greatly affected, since banks can now engage in most of the present 4(c)(8) activities, including such important ones as mortgage banking, consumer lending, leasing, factoring and data processing. But there are other possible interpretations of the proposed wording changes in the "closely related" test, and these different interpretations could have significantly different effects. In any event, the Board believes that it is important to draft any wording changes in the "closely related" test so as to minimize subsequent controversy over the meaning of the test.

The Board also believes that there should be no changes in the "closely related" test without a thorough review and analysis of the impact that bank holding companies have had in the various nonbanking areas since the passage of the 1970 amendments. As the Committee is aware, the Board's staff is nearing completion of a comprehensive review of recent research on all aspects of the bank holding company movement. The Board believes that this study, as well as all other available evidence, should be carefully reviewed and considered before changing the present standards for permissible activities.

The provisions of S. 72 would also alter the "public benefits" test of Section 4(c)(8), making it substantially more stringent. The present statute requires that a proposed activity "can reasonably be expected to produce benefits to the public that outweigh possible adverse effects." S. 72 would require that the activity "is likely to produce substantial benefits to the public which clearly and significantly outweigh possible adverse effects." The specific factors to be considered in determining substantial benefits and adverse effects would also be expanded.

The Board believes that the meaning of the proposed "public benefits" test is likely to produce controversy. But more important, the Board does not believe that the proposed public benefits test would serve the public as well as the existing test. Under the proposed test, the Board would have to deny nonbanking applications if the benefits were less than substantial or if even substantial benefits would only slightly outweigh adverse effects. In contrast, the Board can approve such applications under the present standard. The Board sees no reason to deny the public the opportunity to derive benefits when there is a reasonable probability that these benefits, on balance, will outweigh any adverse effects.

S. 72 would provide grandfather rights for bank holding companies engaged in nonbanking activities that would be made impermissible by the bill.

If S. 72 is enacted, the Board would strongly support grandfather provisions, but would urge that the effective grandfather date be the date that the bill was introduced in the current Congress, rather than November 1, 1975, as proposed in S. 72. Also, we would suggest the elimination of the provision in S. 72 that would prevent a holding company from increasing to any significant degree the volume of business of a grandfathered nonbanking subsidiary. Such a provision would tend to discourage the holding company subsidiary from competing aggressively and meeting the needs of the public.

The bill also specifies that the Board shall require that bank holding companies and their subsidiaries be capitalized and otherwise financed in a safe and sound manner. Certainly this objective cannot be criticized. However, it should be recognized that the Bank Holding Company Act already requires the Board in bank acquisitions to "take into consideration the financial and managerial resources and future prospects of the company or companies and the banks concerned." Similarly, Section 4(c)(8) of the Act requires the Board to consider such possible adverse effects as unsound banking practices in nonbank acquisitions. In carrying out both of these charges, the Board carefully considers the capitalization and overall financial condition of the holding company and its subsidiaries. Furthermore, as part of its ongoing responsibilities for supervising bank holding companies, the Federal Reserve conducts inspections of the parent companies and their nonbanking subsidiaries, examines subsidiary banks that are State member banks, and reviews the examination reports of other subsidiary banks that are examined by either the Comptroller of the Currency or the FDIC.

The bill also specifies that the Board require bank subsidiaries to refrain from discriminating in favor of their parents and nonbank affiliates in making loans or establishing terms and conditions of credit. The Board agrees that the practices referred to are improper if the terms or conditions of the loan are more favorable than the bank would make to a non-affiliated borrower of comparable credit worthiness. But we oppose the provision with respect to the making of loans to subsidiaries which could have the effect of unduly restricting the flow of funds within the holding company organization. At present, bank examiners closely review bank loans to affiliates and will criticize a loan to an affiliate made on preferential terms that are adverse to the bank. It should also be noted that bank loans to holding company affiliates are covered by Section 23A of the Federal Reserve Act. This Act places quantitative limitations on such loans, as well as requiring that all loans be fully secured by high grade collateral. Indeed, the collateral requirements on bank loans to affiliates tend to be significantly more stringent than collateral provisions on bank loans to non-affiliated borrowers. The Board feels that a better way to deal with transactions involving intra-company fund flows is through Section 23A. In this connection, a new proposal to modernize and strengthen Section 23A has been completed by the Board and is being transmitted to Congress.

S. 72 contains a provision that would require each bank holding company to submit to the Board each year a report detailing the terms and conditions of <u>all</u> intra-company loans and investments. Moreover, the Board would be required to make such reports available to the public. The Board does not believe that these provisions are necessary. First, the Board is already receiving an intra-company transactions report on a quarterly basis from medium and large size bank holding companies. Second, bank examiners carefully review transactions between bank subsidiaries and the rest of the holding company system, and the Federal Reserve now periodically inspects the financial affairs of parent companies and nonbank subsidiaries. In the Board's judgment, these examinations and inspections, along with existing reports, supply the supervisory authorities with sufficient information on intra-company transactions. In addition, the potential reporting burden associated with such a proposal would be substantial, especially since most intra-company transactions individually would not be material. The general problem of the appropriate level of public disclosure of insider transactions, of which intra-company transactions are a subset, is currently under review by the SEC, the accounting profession, the banking agencies, and Congress. We believe it preferable to wait until the general issues have been resolved before legislating reporting in this area.

Turning to that portion of the bill dealing with administrative procedures and judicial review, the Board strongly objects to the proposals contained in Section 601. These proposals represent a step backwards to the burdensome and time-consuming procedures of the Bank Holding Company Act

Section 601 would eliminate this administrative flexibility to the detriment of the public interest.

We are equally concerned with the provisions of Section 701 that would require the Board to process a petition to commence a proceeding to consider the issuance, amendment or repeal of any order or regulation relating to nonbank activities. We note that under the Administrative Procedure Act any person already has the right to petition the Board for the adoption or amendment of a regulation. Additionally, we believe that the procedure established to challenge the operation of individual companies would provide a continuing possibility of attacks on a bank holding company wishing to engage in a bank related activity. This possibility could deter many bank holding companies from engaging in nonbanking activities or seriously impair their nonbanking subsidiaries' abilities to compete with unaffiliated companies engaged in the same activity. Such an outcome would tend to reduce competition and innovation in bank related fields, and could hardly be in the public interest.

Percentage of Domestic Statewide Commercial
Bank Deposits in Three Largest
Banking Organizations

Statewide Branching States	1960	1976	Change
Arizona	95.8	86.8	-9.0
Nevada	93.5	83.2	-10.3
Rhode Island	92.8	87.4	-5.0
Hawaii	89.2	78.6	-10.6
Oregon	86.7	78.3	-8.4
Delaware	79.8	76.9	-2.9
Idaho	74.5	75.3	+.8
Alaska	68.2	67.5	-.7
California	65.7	60.4	-5.3
Utah	65.6	60.5	-5.1
Washington	61.1	61.7	+0.6
North Carolina	46.8	49.2	+2.4
Connecticut	42.7	46.6	+3.9
Maryland	42.7	44.6	+1.9
South Carolina	42.4	42.8	+0.4
South Dakota	37.5	44.3	+6.8
Maine	34.7	46.6	+11.9
Vermont	25.6	44.0	+18.4
Virginia	20.2	34.6	+14.4
Average of Statewide Branching States	61.3	61.5	+.2

Limited Branching States	1960	1976	Change
Massachusetts	49.3	45.7	-3.6
Georgia	48.6	37.8	-10.8
New Mexico	43.0	46.0	+3.0
Michigan	40.8	34.2	-6.6
New York	40.0	40.0	0.0
Wisconsin	31.4	27.4	-4.0
Alabama	31.2	37.5	+6.3
Louisiana	29.3	17.8	-11.5
Tennessee	28.7	28.8	+0.1
Pennsylvania	27.9	22.9	-5.0
Kentucky	27.6	20.9	-6.7
Mississippi	24.9	27.7	+2.8
New Hampshire	24.3	33.6	+9.3
Ohio	24.2	24.6	+0.4
Indiana	23.8	18.0	-5.8
New Jersey	16.8	22.2	+5.4
Average Limited Branching States	32.0	30.3	-1.7

Unit Banking States	1960	1976	Change
Minnesota	58.6	51.6	-7.0
Montana	48.7	45.5	-3.2
North Dakota	46.6	40.6	-6.0
Colorado	37.9	41.0	+3.1
Illinois	35.5	31.8	-3.7
Wyoming	35.1	40.3	+5.2
Oklahoma	32.6	20.5	-12.1
Nebraska	31.6	20.0	-11.6
Missouri	26.6	28.9	+2.3
Texas	21.1	20.5	-.6
Florida	17.9	24.5	+6.6
Arkansas	17.3	14.2	-3.1
West Virginia	17.3	9.3	-8.0
Kansas	14.3	9.0	-5.3
Iowa	14.2	15.1	+.9
Average for Unit Banking States	30.4	27.5	-2.9

	1960	1976	Change
Average for All States	42.7	41.3	-1.4