Federal Reserve System Speeches Burns

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Statement by

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before the

Committee on Banking and Currency

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The Board of Governors welcomes your decision to move ahead with hearings on legislation to extend the Bank Holding Company Act of 1956 to cover one-bank holding companies. We think that it is entirely possible as well as desirable to complete such action this year, in view of the wide agreement that exists on the basic principle underlying this legislation. That basic principle is incorporated in section 4 of the 1956 Act, which provides that bank holding companies, with relatively minor exceptions, shall confine themselves to the management and control of banks and related activities.

The 1956 Act required companies that owned two or more banks to divest any nonrelated businesses they then owned if they chose to keep their banks. The reason for this requirement, as set forth in your Committee's report on that legislation, was "to remove the danger that a bank holding company might misuse or abuse the resources of a bank it controls in order to gain an advantage in the operation of the nonbanking activities it controls."

In 1956 and again in 1966, your Committee decided not to apply this principle to companies that own only one bank. In scheduling the present hearings you have recognized, however, the need to reconsider this decision in the light of the new wave of one-bank holding companies formed in the past two years.

Leading this movement are the largest banks in the country. There are 51 banks in the United States with deposits of $1 billion or more. Nine of them are subsidiaries of registered bank holding companies--companies that own two or more banks. Of the other 42 billion-dollar banks, one has been owned by a holding company since 1927. In 1965 another was acquired by a company whose nonbanking assets are considerably larger than those of the bank. Then in late 1967, a third billion-dollar bank created a corporation which in 1967 and 1968 acquired ownership of the bank plus several nonbank subsidiaries, much smaller in size, engaged in fiduciary, mortgage, insurance, real estate investment, and data processing businesses. In the last three months of 1968 five more followed suit. By the end of 1969 there were 15 more, so that out of the 51 billion-dollar banks, 9 were owned by registered bank holding companies, 19 were independent, and 23 were owned by one-bank holding companies. Among the 23 were the 6 largest banks in the country. These 6 banks alone have more deposits than all of the banks in the registered bank holding company systems; indeed, they hold more than a fifth of the deposits in our entire banking system.

Whatever the reasons for exempting one-bank holding companies may have been in 1956 or in 1966, the time is clearly at hand when Congress must decide whether the rules against mixing banking and other businesses in a holding company system should apply to one-bank holding companies or should be abandoned. It is discriminatory to apply these rules solely to the registered bank holding companies, which have fewer banks and a much smaller share of deposits than the exempt companies.

As Chairman Martin testified last year before the House Committee on Banking and Currency, complete enforcement of these rules is needed to guard against undue concentration of economic power. Let me quote from his testimony on this point:

"If a holding company combines a bank with a typical business firm, there is a strong possibility that the bank's credit will be more readily available to the customers of the affiliated business than to customers of other businesses not so affiliated. Since credit has become increasingly essential to merchandising, the business firm that can offer an assured line of credit to finance its sales has a very real competitive advantage over one that cannot. In addition to favoring the business firm's customers, the bank might deny credit to competing firms or grant credit to other borrowers only on condition that they agree do do business with the affiliated firm. This is why . . . if we allow the line between banking and commerce to be erased, we run the risk of cartelizing our economy . . Just as we have seen the country's largest banks joining the new wave of one-bank holding companies, we could later see the country's business firms clustering about banks in holding company systems in the belief that such an affiliation would be advantageous, or perhaps even necessary to their survival."

If this Committee agrees that one-bank holding companies should be covered by legislation, you immediately face the question whether to require those that have unrelated businesses to divest their banks or their nonbank interests in compliance with section 4, which provides that such divestiture shall be completed within two years unless the Federal Reserve Board extends the period up to three additional years.

The Board recognizes that divestiture poses questions of equity to the companies involved, as well as possible adverse effects on communities where forced sales of small banks might result. A majority of the Board recommends, therefore, that holding companies covered under the Act by this legislation be allowed to retain subsidiaries acquired before June 30, 1968, provided they engage only in those activities in which they were engaged on that date. The date of June 30, 1968 would differentiate between the older, and generally smaller, companies and the newer companies formed by the country's largest banks. Most of the nonbank subsidiaries of the latter companies appear to be bank-related, and virtually all of them have been established after June 30, 1968.

Although the problems posed by divestiture are difficult, they will get worse if legislation is delayed. Most one-bank holding companies seem to be refraining from acquiring unrelated businesses, pending an early decision by the Congress on this legislation. But if this session should close without action, it could easily be interpreted as indicating a decision by the Congress to preserve the exemption for one-bank holding companies, thereby leading to expansion by such companies into unrelated fields. Such a development would make the job of unscrambling all the harder when final action on the legislation comes, as I believe it must. To forestall expansion that will be increasingly painful to reverse, we need a law this year--as good a law as can be devised at this time. It will always be possible to make revisions later, if this proves necessary in the light of experience, or advisable in the light of new insights such as may be expected from the studies of the Presidential Commission on Financial Structure and Regulation.

Enactment of a bill that simply covers one-bank holding companies, with whatever grandfather clause you decide is appropriate, would meet the most pressing needs of the moment. At the same time it would be desirable to make several changes in the provisions of section 4 relating to the fields of business that bank holding companies should be allowed to enter. Before suggesting amendments, I think it would be helpful to review the present law and how the Board has interpreted it.

As now written, section 4 of the Act prohibits bank holding companies from engaging in nonbanking activities or owning voting stock of nonbanking organizations, with a number of exemptions. The most important exemptions are in section 4(c)(1)(C), section 4(c)(5), and section 4(c)(8).

Under section 4(c)(1)(C), a bank holding company may acquire interests in a company engaged solely in "furnishing services to or performing services for such bank holding company or its banking subsidiaries." Your Committee's report on the 1956 Act indicated that such services would include "auditing, appraising, investment counseling . . . and many others." The Board has interpreted the exemption to include a mortgage company that acts merely as an adjunct to facilitate operations of one or more of the subsidiary banks. The Board has also interpreted the exemption to include an equipment leasing company operated essentially as a conduit for extensions of credit by subsidiary banks to the lessees of the equipment.

Under section 4(c)(5), a bank holding company may acquire "shares which are of the kinds and amounts eligible for investment by national banking associations." Various statutory provisions explicitly authorize national banks to buy stock of particular organizations, such as safe deposit companies, bank premises subsidiaries, small business investment companies, and so on. The Board has ruled that a member bank may establish a wholly-owned operations subsidiary--that is, an organization designed to serve, in effect, as a separately incorporated department of the bank. This ruling automatically expanded the scope of investments permissible for bank holding companies under section 4(c)(5).

Section 4(c)(8) permits a bank holding company to acquire shares of a company "all the activities of which are . . . of a financial, fiduciary, or insurance nature" if the Board determines that these activities are "so closely related to the business of banking or of managing or controlling banks as to be a proper incident thereto" and thus in harmony with the purposes of the Act. Virtually all of the subsidiaries established under section 4(c)(3) have been insurance companies or agencies. Where an insurance agency is involved, the Board has interpreted the provision as requiring a "direct and significant connection" between the activities of the agency and those of the subsidiary banks. The connection may be established, for example, by the fact that the insurance agency will be housed in bank offices and use bank personnel, or that its income will be derived from bank-related transactions or insurance sold to bank customers. Insurance company subsidiaries (underwriters, as contrasted with agents) have been permitted where all of the insurance is written in connection with bank transactions.

Thus, in its interpretations of the 1956 Act, the Board has recognized that combining banks with functionally related businesses in a holding company system may lead to economies in production, distribution, sales, research, and finance. Economies of production can be achieved where there is a similarity of operations, such as servicing checking accounts and processing payrolls. Consumers can benefit from the convenience of being able to buy insurance on a new car at the time they arrange for its financing--assuming, of course, that the arrangement is entirely voluntary. A research staff can be too expensive for one bank to maintain but pay for itself when the expenses are shared with other subsidiaries in a holding company system. A holding company also may be able to obtain capital funds more easily and less expensively than any of its smaller components.

By weighing the prospects of realizing such benefits against the risks of undesirable consequences, a judgment may be formed about the kinds of services bank holding company subsidiaries should be authorized to provide. In the Board's judgment, authorized subsidiaries might well include those engaged in lending funds on their own account or for the account of others; acting as investment adviser; operating a "no-load" mutual fund; leasing equipment where the lease is really a form of security for financing; performing insurance functions in connection with services offered by other subsidiaries; providing bookkeeping or data processing services; originating, servicing, and selling mortgage loans; acting as travel agent or issuing travelers checks; and making equity investments in community rehabilitation and development corporations engaged in providing better housing and employment opportunities for people of low or moderate incomes. The list of permissible activities should change as times change; we are therefore not recommending that Congress include a specific list in the statute. Rather, we believe the Board should be authorized to specify permissible activities by regulation, after providing interested parties an opportunity for a hearing.

Once a particular activity has been determined to be functionally related to banking, and so permissible for holding companies generally, administrative approval should be required before a holding company could establish a subsidiary to engage in the activity. Approvals could be granted automatically under a notification procedure where the proposal is within guidelines designed to identify situations in which entry would be procompetitive. Applications for establishment of subsidiaries under circumstances that do not meet the guidelines for automatic approval would be granted only where the applicant demonstrated to the Board's satisfaction that approval would serve the public interest.

Guidelines governing such approval would be established by the Board, taking into account the competitive and other factors already specified in the Act as to acquisitions of banks. Thus, an applicant proposing an acquisition involving a relatively large amount of nonbank assets would ordinarily bear a greater burden of proving that the acquisition is not contrary to the public interest. Also, while approval would be required whether the expansion is to be achieved by establishing a new company or by acquiring an existing one, de novo entry would be favored since a company newly entering a market must, of course, face the competition of those already in it.

Under the present provisions of section 4(c), particularly sections 4(c)(1)(C) and 4(c)(5), bank holding companies may acquire or establish subsidiaries to engage in most of the activities I have mentioned. But some modifications in section 4(c)(8) would make it more useful in dealing with activities not covered by sections 4(c)(1)(C) and 4(c)(5). Section 4(c)(8) now requires that a formal hearing be held on each application thereunder, even in the absence of any interest or testimony by anyone other than the applicant. This is a time-consuming and expensive procedure, which should be limited to instances where a hearing is requested by an interested party. It would be helpful, too, to revise the standards set forth in section 4(c)(8) to incorporate the concepts I have outlined. We have in mind a provision permitting any activity that the Board determines, after opportunity for a hearing, is "functionally related to banking in such a way that its performance by an affiliate of a bank holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased competition, conflicts of interest, or unsound banking practices." This standard is in harmony with the standard incorporated in S. 1664; it simply spells out to a greater degree the process by which we believe "related" activities should be identified.

The Board supports in principle the other revisions in section 4(c)(8) incorporated in S. 1664, except for those provisions dispersing administrative authority among the three banking agencies, to which I shall return in a moment.

A revision of section 4 along the lines I have suggested would avoid rigidities such as those incorporated in the House-passed bill. We believe that bill goes too far in protecting insurance agents, travel agents, bookkeepers, mutual funds, and others from competition. Greater freedom of entry into these fields by bank holding companies, subject to safeguards such as I have outlined, would promote the fair competition in the provision of services that the public has a right to expect.

The Board opposes the restrictive approach of the House-passed bill to a definition of banking. Aside from the uncertainties and competitive inequities it would involve, it seems to turn the principles of the 1956 Act upside-down. In 1956 Congress decided that bank holding companies should be confined to activities closely related to banking. But the House bill seems to provide that certain services, including some heretofore considered banking services, are not to be offered by holding company subsidiaries, and therefore should also not be offered by banks. If banks and bank holding companies are to be prohibited from offering service simply because it might compete with a nonbank business, we can expect a stagnant banking system and, perhaps also, a consequent drag on our economy.

Turning to the question of administration of the Act, we believe that it would be most effective to place this responsibility in one agency, and the Board has the advantage of having had experience in this field. Although the Board indicated last year that dispersal of administrative authority would be acceptable if necessary to get a bill, subsequent developments seem to indicate that dispersal would not in fact enhance the prospects for action in this Congress.

Let me comment briefly now on a few remaining issues.

The Board favors broadening the tests of control, as all of the bills before you would do, to cover situations where control is exercised in fact through ownership of less than 25 per cent of the voting stock.

In view of the recent use of the partnership form to bring several banks in Michigan and other States under common control, the definition of "company" should be extended to cover partnerships, as all of the bills before you would do.

The House-passed bill, as we understand it, would require a bank that held in its trust department a controlling interest in the stock of another bank to register and file reports under the Act; but such a bank could continue to acquire stocks of other banks in a fiduciary capacity without Board approval, in view of the exemption in section 3 of the 1956 Act, which would be retained. The Board believes that something beyond reporting is needed to assure that acquisitions through trust accounts are not used to circumvent the purpose of the Act. Outright repeal of the exemption in section 3, however, would interfere drastically with the ability of banks to offer fiduciary services. We recommend, instead, that the exemption in section 3 be limited, as to bank stock, to cases where the trustee bank obtains voting instructions from the beneficiary.

The House-passed bill would repeal the exemption for labor, agricultural, and horticultural organizations in section 4(c) of the Act; the Board has repeatedly recommended that this be done.

We also recommend that the exemptions in section 4(c)(5) and section 4(c)(9) be amended, as provided in S. 1664, so as to preclude the possibility that a bank might establish a holding company to acquire a foreign bank without obtaining Board approval, which would be required under section 25 of the Federal Reserve Act if the bank made the acquisition directly.

Coverage of one-bank holding companies requires a new look at how the Act should apply to foreign banks and bank holding companies. Several banks chartered in New York and California are subsidiaries of foreign one-bank holding companies. A number of foreign-chartered banks have offices of one kind or another in this country. Taken literally, the definition of "bank" in section 2(c) of the Act, together with section 2(h), would seem to apply the divestiture requirements of section 4 of the Act in a number of these situations. The Board sees no useful purpose in this. We think the objectives of the Act can be accomplished without covering foreign-chartered banks and without covering domestically-chartered banks that do no business in the United States except as an incident to their foreign operations. Moreover, we believe bank holding companies that are principally engaged in banking abroad should be allowed to retain interests in foreign-chartered nonbanking companies that are also principally engaged in business outside the United States. We do not believe Congress intended the Act to be applied in such a way as to impose our ideas of banking upon other countries. To do so might invite foreign retaliation against our banks operating abroad, to the detriment of the foreign commerce of the United States. The provisions of the House-passed bill authorizing the Board to grant exemptions in this area would be most useful in dealing with these problems.

In summary, the Board recommends that your Committee report favorably a bill that would--

First, amend the definition of "bank holding company" to include companies that control only one bank, as provided in all of the bills before you;

Second, include a grandfather clause dated June 30, 1968, as provided in S. 1664;

Third, revise the standards in section 4(c) regarding permissible activities, along the lines mentioned in this statement;

Fourth, make more limited changes, chiefly to broaden the test of control, cover partnerships, and permit foreign bank holding companies to retain foreign nonbanking interests.

This is the outline of legislation the Board would like to see. In closing let me repeat that it is my hope--as well as the hope of the other members of the Board of Governors--that Congress will pass a one-bank holding company bill this year. Action is needed now, before large banks make substantial acquisitions in unrelated fields through their one-bank holding companies. Action is needed now, while it is still possible to preserve a reasonable distinction between banking and industry without undue hardship either to the companies themselves or to the economy and the nation. We should not let the basic prupose of this legislation stray from our minds. Nor should we permit details or technicalities to distort our focus on this basic and most important issue. The Board stands ready to cooperate with the Committee in any way you call upon us in your consideration of this legislation.