1970 Bank Holding Company Amendments

What Is "Closely Related to Banking?"

by Charles D. Salley

If whaling were a regulated industry, we should likely find ourselves wondering whether the Bureau of Fisheries or the Bureau of Animal Husbandry has jurisdiction. "Whales ply the waters and have fins. They are clearly fish and are, therefore, of concern to us," one bureau chief would assert.

"If that is your criterion," might come the rebuttal, "then you would have to regulate submarines as well. Whales, on the contrary, are warm-blooded and give milk. Clearly, they are mammals and should come under control of the Bureau of Animal Husbandry."

The experts would then be consulted. The zoologists, of course, had faced this problem of classification many years ago. The whale, although it has many structural characteristics in common with both fish and mammals, is indeed a mammal. They based this answer to their dilemma on the concept of evolution. The whale is more closely linked with mammals through a common community of origin and development.

Now, banking is a regulated industry, and we are finding ourselves in the midst of a similar dilemma. The one-bank holding company, a behemoth equally elusive of category, has recently surfaced amid bank regulatory policy. Is it a creature of banking or of commerce?

The Board of Governors of the Federal Reserve System has the task of making this distinction. Under the 1970 Amendments to the Bank Holding Company Act of 1956, the Board may permit bank holding companies

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to acquire only those nonbanking firms that it classifies as **closely and properly related to banking.**

This article reviews the provisions of the new holding company act and the problem that the Federal Reserve now faces in constructing a banking-nonbanking classification. To understand what the Board must do, let us first take a look at the 1956 legislation.

The Bank Holding Company Act of 1956

The initial Bank Holding Company Act was concerned primarily with the acquisition of additional banks by a banking organization. The Act, together with the 1966 Amendments, directed the Board of Governors to approve only those bank acquisitions that would be soundly managed, that would benefit the convenience and needs of the communities involved, and that would have no serious anticompetitive effects. The unique feature of the legislation provided that the Board can approve a bank acquisition that would lessen competition—short of an actual or attempted monopoly—if these anticompetitive effects are clearly outweighed by the public interest benefits. This is more a public utility approach to structural regulation than an anti-trust approach. It reflects a concern for bank stability and public convenience as well as for competition.

In addition to bank acquisitions, the 1956 legislation also provided for holding company acquisition of nonbanking subsidiaries. Under Section 4(c)(8),[1] such acquisitions were permissible where the activities of the nonbanking subsidiaries were closely related to the business of banking as conducted by the holding company or its subsidiary banks.

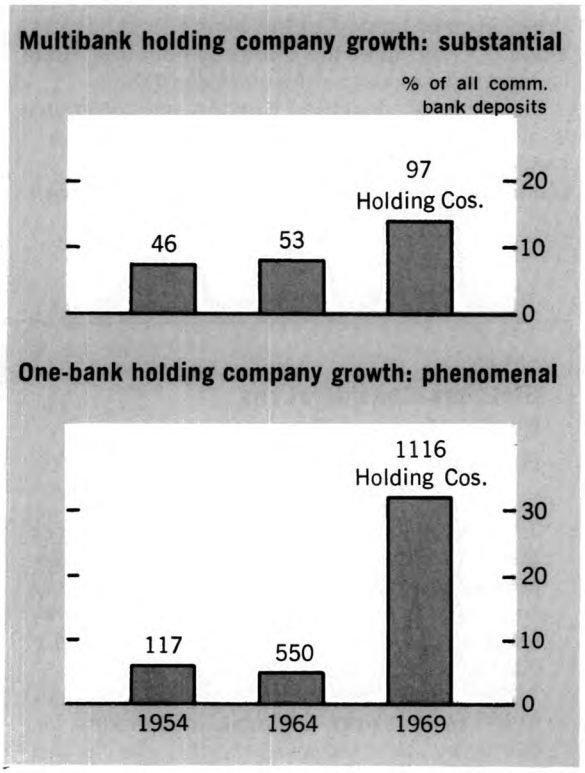
The Act did not, however, govern holding companies with only one bank. Only multibank companies were required to register and come under the Board's jurisdiction. This was intended to exclude the many small, family-owned companies pursuing more than a single business.

Growth of the One-Bank Holding Company

After passage of the 1956 Act, and especially in recent years, a phenomenal number of large banks formed one-bank holding companies and established subsidiaries that engage in numerous commercial activities. There are several incentives for such reorganization. One is a need to obtain new sources of loanable funds. For many years, the primary source of bank funds, demand deposits, has declined as a percent of bank liabilities. During the 1960's, imaginative bank management had to focus on liabilities. This was especially true in periods of monetary restraint.

Moreover, bankers found that their investment in computer capacity and trained personnel gave them additional productive capability. Banks could offer additional services that utilize similar equipment and skills already in operation. This possibility drew management's attention to product expansion. They had already made the initial investment required to sell insurance, to underwrite revenue bonds, to perform accounting, data processing and leasing services, and to operate mutual funds.

Just as the multibank holding company had appealed to bankers as a vehicle for geographic expansion in the 1960's, the one-bank holding company now appealed as a vehicle with the flexibility needed to obtain funds and to expand services in the Seventies. Thus, by the end of 1969, there were 1,116 one-bank organizations controlling 32 percent of U. S. bank deposits. This expansion appeared to threaten the traditional separation of banking and commerce and resulted



[1] *Numbered Section 4(c)(6) prior to the 1966 Amendments.*

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in Congressional passage of the Amendments of 1970.

Why Separate Banking and Commerce? At one time in the United States, banking was looked upon by frontier developers as a means of securing funds for long-term capital investments such as railroads. Since the Civil War and the National Banking Act, however, the concept that the business of banking should be strictly banking has been a major tenet of bank regulation. In other words, banks should not directly undertake production or become otherwise entangled with commerce. This tenet is based primarily upon the historically justified concern for the safety of depositors' funds. These short-term liabilities should not become immobilized in the relatively fixed asset structure of commercial and industrial ventures. Inventories, much less plant and equipment, are not readily converted into cash on demand. Should a bank fail to make such conversion and eventually close its doors, the losses are not limited to the bank's stockholders alone but fall upon the entire community. There is, therefore, a concern for banking stability.

The tenet of separating banking and commerce is also based upon the underlying economic concern for the efficient allocation of credit. Economic theory and the American experience have found that this, as with the allocation of any scarce resource, is best accomplished by many decision units competing at arms length in the marketplace. The direct linking of a number of these decision units, whether banks or commercial firms, can result in funds or other resources flowing into the immediate production of certain goods and services to which the consuming economy would not otherwise assign as high a priority. Thus, policy makers have tended to discourage the affiliation of banks, the affiliation of business firms, and the affiliation of banks with business firms. There is, in other words, a concern for competition.

Because of the concern for stability and for competition, regulators are wary of possible conflicts of interest and tie-in arrangements that might be brought about by the affiliation of banking and commerce. Preferential treatment in the granting of a loan by a holding company's bank to its commercial subsidiary might result in the funding of a risky, though profitable, undertaking that would not, otherwise, pass the purview of the bank's loan officer. Such a credit extension would jeopardize the safety of depositors' funds.

At the same time, preferential treatment might enable the subsidiary to continue as an inefficient producer or to gain an advantage over its competitors and, thus, artificially restrict production and raise prices. Such a credit extension would adversely affect market competition.

Statutory Considerations By the Board of Governors in Nonbank Acquisitions

The Bank Holding Company Act requires the Board, under Section 4(c)(8), to determine that the activities engaged in by the company to be acquired are so closely related to banking or managing or controlling banks as to be a proper incident thereto.

In determining whether a particular activity is a proper incident to banking or managing or controlling banks, the Board must consider whether its performance by an affiliate or a 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 or unfair competition, conflicts of interest, or unsound banking practices.

The Amendments of 1970

With the goals of stability and competition in mind, and with the expansion of holding companies into nonbanking activities threatening the separation of banking and commerce, Congress enacted the Bank Holding Company Act Amendments of 1970. The new legislation extends the Federal Reserve Board's jurisdiction under the 1956 Act to one-bank holding companies and to companies that own less than 25 percent of a bank's voting stock but that, nevertheless, exercise control. It also prohibits certain tie-in arrangements, and (of concern to this article) it further specifies the evaluation of nonbanking acquisitions under Section 4(c)(8).

The Board must now determine whether the activity of a proposed nonbanking subsidiary (1) is so closely related to banking (2) as to be a proper incident to banking. In its determination of the activity's propriety to banking, the Board must specifically consider factors that might undermine banking stability and that might have adverse competitive effects. As with bank acquisitions, the Board can approve a nonbank acquisition if there are resulting public benefits that outweigh these possible adverse effects.

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The Problem of Classification

The Board's task under the new Section 4(c)(8) is to classify proposed holding company activities as closely related to banking and as properly related to banking. Such systematic classification of observed phenomena—whether banking and nonbanking activities or fish and whales—is as old as human inquiry. Empirical science has regarded classification as the first step to rational apprehension, leading to generalization and then to predictability. If an object has the traits typical of those objects classified as fish, it is predictable that it will swim off when thrown into the water. If an object exhibits traits typical of those classified as monopoly, it is predictable that it will restrict output and raise prices.

Strict boundaries for classifications, though, are difficult to establish. Rather than establish hundreds of neat pigeonholes, an investigator often constructs a scale running between two polar types. A market is rarely purely monopolistic (one firm) or perfectly competitive (many firms), but lies somewhere between the two extremes.

Thus, the concept of strict class generally fades into a comparative measure of some trait. In this case, markets are classed according to the **number** of firms; the fewer the firms, the more monopolistic the market. The problem of classification, then, actually lies in the choice of this basic trait.

Standard Industrial Classification

In classifying industries, economists often place several firms in the same industrial category if the firms produce similar products. The basic trait chosen for the classification is product substitutability. For instance, several brands of soft drinks are close substitutes for each other; increased consumption of one generally results in decreased consumption of the other. They are substitutes or competing goods and are placed in the soft drink industry. On a larger scale, soft drinks compete with beer, and both activities are placed in the beverage industry.

Economists call the degree of substitutability in consumption "cross-elasticity." Soft drinks and beer have a degree of cross-elasticity; soft drinks and ink do not. Such a cross-elasticity classification is oriented to the demand side of the market, that is, toward the point of view of purchasers.

On the other hand, it is also possible for economists to orient an industrial classification to the supply side of the market, or toward the producer's point of view. Some products that are substitutable in consumption, like glass jars and aluminum cans, have such different production

Major Categories
Standard Industrial Classification

- 01 Agriculture, Forestry, Fisheries
- 10 Mining
- 15 Construction
- 19 Manufacturing
- 40 Transportation and Communication
- 50 Wholesale and Retail Trade
- 60 Finance, Insurance and Real Estate
  - Banking
    - 601 Federal Reserve Banks
    - 602 Commercial and Stock Savings Banks
    - 603 Mutual Savings Banks
    - 604 Nondeposit Trust Companies
    - 605 Exchange, cashing, and safe deposit companies
  - Credit Agencies
    - 611 Rediscount Institutions
    - 612 Savings and Loan Associations
    - 613 Agricultural Credit Institutions
    - 614 Personal Credit Institutions
    - 615 Business Credit Institutions
    - 616 Loan Brokers
  - Security and Commodity Brokers
    - 621 Security Brokers
    - 622 Commodity Brokers
    - 623 Exchanges
    - 628 Exchange and Transfer Services
  - Insurance Carriers
    - 631 Life Insurance
    - 632 Accident and Health Insurance
    - 633 Fire, Marine, and Casualty Insurance
    - 635 Surety Insurance
    - 636 Title Insurance
    - 637 Carriers not classified elsewhere
  - Insurance Agents and Brokers
  - Real Estate
    - 651 Operators and Lessors
    - 653 Agents and Brokers
    - 654 Title Abstract Companies
    - 655 Developers
    - 656 Operative Builders
  - Combination Real Estate and Law Offices
  - Holding and Investment Companies
- 70 Services
- 91 Government

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BANK HOLDING COMPANIES

SECTION 4 [C] [8] DETERMINATIONS

Applicant	Nonbanking Companies	Action	Federal Reserve Bulletin Citation
Transamerica Corp., San Francisco, Calif.	Occidental Life Insurance Co.	Denied	1957 BULL. 1014
General Contract Corp., St. Louis, Mo.	23 subsidiaries of various types	Denied	1958 BULL. 260
Financial Institutions, Inc., Warsaw, N. Y.	Geneva Shareholders, Inc.	Granted	1958 BULL. 1162
Otto Bremer Co., St. Paul, Minn.	5 insurance agencies	Granted with conditions	1959 BULL. 892
First Bank Stock Corp., Minneapolis, Minn.	First Bancredit Corp. First Service Agencies	Denied Granted	1959 BULL. 917
Bank Shares, Inc. Minneapolis, Minn.	4 insurance agencies	Granted	1959 BULL. 954
Northwest Bancorporation, Minneapolis, Minn.	Northwestern Mortgage Co. South Side Insurance Agency Union Investment Co.	Denied Granted Granted	1959 BULL. 963
Wisconsin Bankshares Corp., Milwaukee, Wis.	First Wisconsin Co.	Granted	1959 BULL. 1136
First Virginia Corp., Arlington, Va.	2 insurance agencies	Granted	1959 BULL. 1247
Union Bond & Mortgage Co., Port Angeles, Wash.	Forks Building Corp. Peninsula Investment Co. Citizens Building Corp. First American Insurance Agency	Denied Denied Denied Granted	1960 BULL. 152
Otto Bremer Co., St. Paul, Minn.	Foster County Agency	Granted	1960 BULL. 621
Otto Bremer Co., St. Paul, Minn.	Western State Credit Co.	Granted	1961 BULL. 23
St. Joseph Agency, Inc., South Bend, Ind.	St. Joseph Insurance Agency, Inc.	Granted	1961 BULL. 290
Montana Shares, Inc., Havre, Mont.	Montana Agencies Liberty Corp.	Granted	1961 BULL. 767
Otto Bremer Co., St. Paul, Minn.	Farmers State Agency, Inc. Citizens Agency, Inc. Warren Agency, Inc.	Granted	1961 BULL. 1039
The Virginia Commonwealth Corp., Richmond, Va.	Virginia Standard Corp. State-Wide Insurance Agency, Inc.	Granted Granted	1963 BULL. 934
Otto Bremer Co., St. Paul, Minn.	Alex State Agency, Inc. Detroit State Agency, Inc. Farmers and Merchants Breckenridge Agency, Inc. Lisbon Insurance Agency, Inc. Polk County State Agency, Inc. Walsh County Insurance Agency, Inc.	Granted	1963 BULL. 1389
First Oklahoma Bancorporation, Inc. Oklahoma City, Okla.	First Oklahoma Baninsurance, Inc.	Granted	1965 BULL. 676

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Applicant	Nonbanking Companies	Action	Federal Reserve Bulletin Citation
First Wisconsin Bankshares Corp., Milwaukee, Wis.	First Wisconsin Co.	Granted	1965 BULL. 680
First Virginia Corp., Arlington, Va.	First Virginia Life Insurance Agency, Inc.	Granted	1967 BULL. 373
Otto Bremer Co., St. Paul, Minn.	Farmers Insurance Agency, Inc. American Insurance Agency, Inc. International State Insurance Agency, Inc. Farmers Agricultural Credit Co., Inc. Carrington Credit Co.	Granted	1967 BULL. 1555
Otto Bremer Foundation, St. Paul, Minn.	Farmers Insurance Agency, Inc. American Insurance Agency, Inc. International State Insurance Agency, Inc. Farmers Agricultural Credit Co., Inc. Carrington Credit Co.	Granted	1967 BULL. 1559
Denver U. S. Bancorporation, Inc., Denver, Col.	Lincoln Agency, Inc. Fidelity National Life Insurance Co.	Granted	1968 BULL. 233
Otto Bremer Co. and Otto Bremer Foundation, St. Paul, Minn.	State Agency of Redwood Falls, Inc. American State Agency of Watertown, Inc. Cassabanka Insurance Agency, Inc. Elk Valley Agency, Inc. Citizens Insurance Agency, Inc.	Granted	1969 BULL. 388
First Security Corp., Salt Lake City, Utah	First Security Life Insurance Co. (or Firsco Life Insurance Co.) First Security Agency, Inc.	Granted	1969 BULL. 667
The Citizens and Southern Holding Company and The Citizens and Southern National Bank, Atlanta, Ga.	American Southern Life Insurance Co. The Citizens and Southern Agency, Inc.	Granted	1969 BULL. 673
Dacotah Bank Holding Co., Aberdeen, S. D.	Citizens Agricultural Credit Corp. F & M Agricultural Credit Corp. Citizens Insurance Agency, Inc. Roslyn Insurance Agency, Inc. Security Insurance Agency, Inc.	Granted	1970 BULL. 469
Central Banking System, Inc., Oakland, Calif.	Cenval Agency, Inc.	Granted	1970 BULL. 477
The First National Bancorporation, Inc., Denver, Col.	Diversified Insurance, Inc. Guaranty Insurors, Inc.	*	1970 BULL. 544
United Virginia Bankshares, Inc. Richmond, Va.	United Virginia Insurance Agency, Inc.	Granted	1970 BULL. 599
Otto Bremer Co., and Otto Bremer Foundation, St. Paul, Minn.	Farmers State Agency of Frederic Bank of Willmar Agency, Inc. Peoples State Agency of Colfax, Inc. Shelby State Agency, Inc. Washburn State-Bayfield Agency, Inc. Union State-Webster, Inc.	Granted with conditions	1971 BULL. 53

*Special permission to appeal granted; hearing to be reconvened later

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processes that the technical similarity of the production process with other products appears to be a more suitable basis of classification. The Bureau of the Budget's Standard Industrial Code takes this supply approach.

Suppose we wish to place firms producing soft drinks, milk, and orange juice into industrial categories. The demand basis would find that these commodities are similar in that they exhibit a degree of demand cross-elasticity. Therefore, the firms make up a single category, the beverage industry. The SIC code, however, would use the similarity of their production processes with those of other commodities as the basis of classifying the firms into the beverage, dairy, and frozen foods industries, respectively.

The point of our discussion is that an industry classification can be based upon either trait—product similarity or process similiarity. The choice would likely depend on the importance of the trait to the objectives of the regulatory policy for which the classification is made.

The Classification of Banking in Bank Acquisitions

The classification of the banking industry also entails choosing a basic trait. Identifying an essential banking trait, although a difficult problem, is one regulators have faced before.

When the Justice Department objected to the merger of the Philadelphia National Bank and Girard Trust Corn Exchange in 1963, identifying banking's essential product line became crucial. Two basic concepts of banking emerged during this important Supreme Court case. One was an extension of the standard economic model of a multiple-product firm. Such a firm produces and sells a number of distinct products to separate groups of customers. This view considers a bank to be an investment firm offering deposit and payment services, seasonal loans, term loans, mortgages, trust services, credit cards, and so on. A bank sets prices and seeks a profit in each of these product areas. The popular literature calls this emphasis on several distinct product lines "department store banking."

The second concept of banking in the Philadelphia case viewed banking as a composite service industry, not as a producer of distinctive product lines. The emphasis here is on a steady-customer relationship. A bank seeks a total profit from the customer over a period of time rather than a profit from each product line. In periods of credit restraint, it will often sell investments to accommodate long-standing deposit customers, even at the expense of incurring capital losses on securities. Its other services are offered merely as an accommodation to the deposit customer. Thus, the concept considers the product of banking to be the "bundle of services" that a bank renders to its steady deposit customers.

The lower courts had subscribed to the first concept of a bank as a multiproduct firm. They viewed credit as the primary product, with various broad national markets for different lines. The Philadelphia merger probably would not monopolize these national markets. Conversely, the Supreme Court accepted the alternate concept, i.e., banks sell a composite service; hence, banking is a single line of commerce in a fairly narrow, localized market. On this basis, the Supreme Court reversed the lower courts and enjoined the merger.

Even though the multiproduct concept and the composite-service concept are based on different traits, both traits appear to produce a demand-oriented classification. The former classifies banking according to cross-elasticities of demand for separate products and services. The latter classifies banking according to the cross-elasticity of demand for a composite service.

The Classification of Banking in Nonbank Acquisitions

Bank regulators have also faced the problem of classifying banking elsewhere, including the area of nonbank acquisitions by holding companies. Recall that the Bank Holding Company Act of 1956, in addition to bank acquisitions, also provided for acquisition of nonbanking subsidiaries by multibank holding companies under Section 4(c) (8).

From September 1957 until January 1971, the Board of Governors made 31 rulings involving 107 nonbanking subsidiaries of multibank holding companies. These subsidiaries were primarily insurance companies, insurance agencies, agricultural credit companies, instalment loan companies, and real estate management companies. All came within the threshold criterion that nonbanking subsidiaries exempted from divestiture must be of a financial, fiduciary, or insurance nature.

Each hearing, then, had to determine if the activity as conducted by the holding company (1) were related to banking and (2) whether so closely related as to make it a proper incident to the business of banking. An activity was properly related to banking if it conformed to the purposes of the Bank Holding Company Act.

The Board, in the first hearing in 1957 (Transamerica Corporation-Occidental Life Insurance Company), recognized one of these purposes to be the separation of banking and commerce. The purpose of Section 4 is "to remove . . . **potential** . . . sources of evil." A holding company should not be so structured, the Board specified as to **enable** a subsidiary to obtain preferential

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treatment over that of their competitors in obtaining bank credit. Proof of the existence of actual discriminatory conduct is not necessary.

In this ruling, the Board decided that there are enough similarities in the operations of a bank and of an insurance company to make them closely related. However, because of the dissimilarities—primarily demand deposits—and the structural capability of self-dealing, the Board ruled that insurance carrying is not a proper incident to banking. It required Transamerica to divest the insurance subsidiary.

The next year, in its second hearing (General Contract Corporation), the Board again ruled that general insurance subsidiaries tend to augment the danger of tie-in arrangements, violating the purpose of Section 4. It did rule, however, that credit life and collateral property insurance are directly connected with lending transactions. Hence, the Board ruled, these activities are properly related to banking, since there is no occasion for their use outside the area of lending.

In 1959, during the fourth hearing (Otto Bremer Company), the Board disqualified real estate agencies but permitted general insurance agencies. Insurance agencies, according to the Board, are closely related to banking because, in this instance, there was complete operational integration of the agency with the bank. As part of a full financial service, it offered insurance services to established banking customers. It was properly incidental to banking because such agencies were sufficiently prevalent among competing banks to give no rise to preferential treatment or to competitive advantage.

In the following case in 1959 (First Bank Stock Corporation), the Board ruled against the multistate purchase of instalment paper by a subsidiary for resale to affiliated banks. The activity was closely related to the banks' lending operations, the Board's opinion stated. And although soliciting and servicing such paper would be properly incidental to banking, actual purchase would not be. In purchasing such third party paper, local bank officers would not be ruling directly on credit allocation. Also, independent banks would not be able to marshal the capital needed to undertake a similar operation and would suffer a competitive disadvantage.

In subsequent rulings from 1959 to 1971, the Board concluded that subsidiaries acting as insurance agents do not have to restrict their activities exclusively to bank customers. Insurance affiliates, however, can underwrite credit life and collateral policies if they limit this service to their affiliated bank customers and personnel. The Board also approved of subsidiaries dealing with agricultural loans sold to the Federal Intermediate Credit Bank.

What Is "Closely Related to Banking?" In these decisions, the Board appeared to recognize two banking traits in determining whether the activities are closely related to banking. The first trait is process similarity to bank lending. The Board found that finance companies, commercial paper companies, and factors all exhibit process similarities in the lending activity that allow them to be placed in the category "closely related to banking." The subclasses are implied in terms of the final liabilities involved, i.e., whether credit paper is purchased with or without recourse.

The second trait recognized by the Board in establishing the closeness of an activity's relation to banking appears to be operational integration of the activity into the bank lending process. Underwriting credit life insurance is operationally integrated into the lending transaction and is, therefore, closely related to banking. On the other hand, ordinary life and property insurance is not a part of the lending process. It is operationally integrated with a bank only through common bank personnel and customers. Therefore, only the agency function, and not the underwriting of such insurance, is closely related to banking.

What Is "Properly Incidental to Banking?" In determining whether an activity is properly incidental to banking, the Board's decisions also appeared to recognize two banking traits. One trait is the avoidance of the structural possibility (potential) for conflicts of interest. This could result in misallocation of credit and threaten banking stability. The second trait is the ability—potential or existing—of competing banks to perform the same activity and, thus, avoid any competitive disadvantage.

An interesting observation is that these classifications of banking in nonbank acquisitions are on the production or supply side, much like the SIC classification. The classifications in the Philadelphia bank acquisition case were on the demand side.

Conclusion

As pointed out, holding companies are anxious to expand into new activities to exploit their newly developed capabilities and excess capacity. Which of these many possible new activities are **so closely related to banking** as to be **a proper incident to banking?** Although the theory of classification tells us how to use criteria to make this determination, the regulatory record of both banking and nonbanking acquisitions reveals that there are a number of possible criteria to use.

The choice of a criterion, as previously indicated, usually depends on its importance to the purpose for which the classification is made. If a banking classification is made for a regulatory policy

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concerned primarily with stability of depositors' funds, the criterion probably will be a measure of liquidity and risk. If, though, the banking classification is made for a regulatory policy concerned primarily with competition and efficient resource allocation, the criterion probably will be a measure of process capability.

More than likely, the classification of an activity under the new holding company act as closely and properly related to banking, then, will reflect the purposes of traditional bank regulatory policy. If so, it will be a dual proposition: properly related to banking stability and properly related to banking competition. Which aspect the Board of Governors chooses to emphasize under the new Act should significantly affect not only the classification but our future banking structure as well.■

Note: Available upon request:

Atkinson, Emerson, "A Decade of Sixth District Bank Merger Activity," this Review, *April 1971, pp. 62-70.*

Salley, Charles D., "A Decade of Holding Company Regulation in Florida," this Review, *July 1970, pp. 90-99.*

Recent Publications

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A Review of Mississippi's Economy, 1960-71, revised June 1971.

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