3/15/38

MEMORANDUM IN RE SENATE BILL 3575
"BANK HOLDING COMPANY ACT OF 1938"

The following questions have been considered in connection with the above Bill:

1 - MAY A BANK HOLDING COMPANY PURCHASE THE REMAINING STOCK INTERESTS OF ANY BANK ALREADY CONTROLLED BY IT, INCLUDING DIRECTORS' QUALIFYING SHARES WHICH IS HAS CONTRACTED TO PURCHASE in case of death or disability?

The answer to this question is found in Sec. 4, which makes it unlawful for any company to acquire the capital stock of an insured bank if such company is or would become a holding company as defined in the Act. A holding company of an insured bank means any company controlling the insured bank or controlling any other company which in turn controls the insured bank. The term "control" as defined in the Bill includes not only actual control, but ownership of 10% of the stock entitled to vote for directors. Consequently, under Sec. 4, no holding company may increase its holdings of stock issued by an insured bank, even though the holding company already has most, or nearly all, of the shares of such bank. Sec. 4 contains no saving clause with respect to contracts made before the effective date of the Bill. Consequently, it would become unlawful to carry out a contract previously made if under such contract the holding company would increase its holdings of capital stock of any insured bank. This section takes effect immediately upon the effective date of the Bill.

2 - MAY A HOLDING COMPANY SUBSCRIBE TO ADDITIONAL STOCK OF A BANK ALREADY CONTROLLED BY IT?

It may be in the interests of the depositors and the public that an insured bank increase its capital stock, thereby maintaining or improving its financial condition. This situation is contemplated in the form of the agreement which the Board of Governors of the Federal Reserve System requires bank holding companies to enter into as a condition to the granting of a Voting Permit to such bank holding companies. In the form of agreement, the bank holding company undertakes and agrees among other things as follows:

> That the undersigned will take such action within its power as may be necessary to cause each of its subsidiary banking institutions to maintain a sound financial condition and to cause the net capital and surplus funds of each such subsidiary banking institution to be adequate in relation to the character and condition of its assets and to the deposit liabilities and other corporate responsibilities of such subsidiary banking institution;

In some cases a bank holding company, instead of subscribing to additional stock of the insured bank, may be willing to make a contribution to surplus without having any additional stock issued to it, but manifestly the bank holding company would not be willing to do this unless it owned substantially all of the outstanding stock of the insured bank. If it held only 10% or even 70% of such stock, it would not be willing to make a contribution to surplus as that would amount to a gift to the other holders of the stock of the bank. Hence, the effect of the above provision would be the interposition of a tremendous obstacle

or lack of incentive on the part of the holding company to keep its controlled banks in sound financial condition through additional subscriptions to capital stock. By reason of the express provision of Sec. 4, the above question must be answered "no".

3 - MAY A HOLDING COMPANY ESTABLISH A BRANCH OF ANY CONTROLLED BANK IN ANY CITY OR COUNTY IN WHICH A BANK MAY BE LOCATED, EVEN THOUGH THE STATE LAW PERMITS SUCH A BRANCH?

The answer to this question is "no". Sec. 5 expressly provides that no insured bank shall establish any new or additional branches while the insured bank is controlled by any holding company. Consequently, any insured bank controlled by a holding company is at a tremendous disadvantage as compared with other competing banks in the same vicinity. The policy of the national banking act heretofore has been to permit branch banks to the extent that state law permits said banks to have branches, this for the purpose of enabling national banks to have asstrong a competitive position as state banks. This same national policy is reflected in laws permitting national banks to maintain trust departments in competition with state trust companies, and in the laws which prohibit discrimination in the state taxation of national bank stock. It is submitted that no public interest requires the prohibition created by Sec. 5. Furthermore, it must be noted that this prohibition is applicable to insured banks even though they are not in fact controlled by a holding company. If the so-called holding company owns only 10% of the voting stock of the bank, the bank must suffer the disadvantage created by Sec. 5, even though the bank is in fact controlled by the remaining 90% of the stock not held by a holding company. Even if it is assumed that under the laws of some states, branch banks are permitted to be established over too wide an area, as for example on a state-wide basis, nevertheless banks in which a holding company has a controlling interest could safely be permitted to establish branch banks within the same economic community, as for example the county in which the bank operates, if permitted by state law.

4 - IF A HOLDING COMPANY OWNS TWO OR THREE BANKS WITHIN A CITY, ONE OF WHICH IS A NATIONAL BANK AND TWO ARE STATE BANKS, MAY THE NATIONAL BANK ACQUIRE THE TWO STATE BANKS IN THE SAME CITY AND ESTABLISH BRANCHES IN THEIR STEAD AT THE SAME LOCATIONS?

This question must be answered "no". While it seems that the pending bill would not prohibit the national bank in question from acquiring the assets of the two state banks, yet Sec. 5 would prohibit the national bank from establishing or operating new or additional branches. The branches here proposed would be new, even though they would take the place of state banks formerly operated in the same locations. Certainly the Bill should not prohibit the establishment of new branches to take the place of other controlled banks within the same county.

5 - MAY A HOLDING COMPANY CAUSE A BANK NOT CONTROLLED BY IT TO BE MERGED OR CONSOLIDATED WITH A BANK WHICH IS CONTROLLED BY IT?

Apparently there is no provision in the Bill which would prohibit a controlled bank from acquiring for cash and the assumption of liabilities, the assets of a bank not so controlled. In such case, the bank whose assets are being so acquired would be liquidated, and neither the holding company nor the controlled bank would acquire the capital stock or any portion of the capital stock of the bank whose assets are so acquired. However, in that case, the controlled bank could not issue any additional stock to the holding company, even though it

obtained from the holding company the funds with which it would purchase the assets of the other bank. Frequently it is in the public interest to have a strong bank acquire the assets and assume the liabilities of a weaker bank in the same vicinity. This situation arose many times during the bank crisis of the last few years. The assumption of the deposit liabilities of the bank whose assets are to be acquire may require an increase in the capital stock of the bank acquiring such assets. Usually the only place where the controlled bank can acquire capital is from the holding company which controls it. Unless the holding company is permitted to subscribe to additional stock of the bank which is to acquire the assets of another bank, it would be most reluctant to supply the additional capital needed by its controlled bank for such purpose. Thus, the effect of Sec. 4 in cases of this kind would be contrary to the interests of the public and particularly the interests of the depositors of the weaker bank, which, but for the provision in Sec. 4, would be able to have its deposit liabilities assumed by a stronger bank.

Apparently the pending bill would not prohibit a non-controlled national bank from consolidating with a controlled bank under the charter of the controlled bank, under Title 12 U.S.C., Section 33, with the consent of the Comptroller of the Currency. However, in case of consolidation under such section, Sec. 4 of the pending Bill would prohibit the consolidated association from issuing any additional stock to the holding company in consideration of any funds which the holding company might supply in order to finance the consolidation and to justify the assumption of the deposit liabilities of the bank so consolidated with the controlled bank. The observations above made with respect to the acquisition of the assets of one bank by another apply with equal force to statutory consolidations. The same observations would also apply to the consolidation of a non-controlled state bank with a controlled national bank under Title 12, U.S.C., Sec. 34-a.

It may also be noted that in the event that the uncontrolled bank whose assets are so acquired, or which is so consolidated with the controlled national bank, has any branches, the branches would have to be discontinued because of the prohibitions in Sec. 5 to the effect that no insured bank shall establish any new branches.

It follows that the above question must be answered "yes", but the obstacles proposed by Sections 4 and 5 would make it exceedingly difficult in many cases to merge or consolidate an uncontrolled bank with a controlled bank.

6- MAY A CONTROLLED STATE BANK OWNED BY A HOLDING COMPANY BE CONVERTED INTO A NATIONAL BANK?

The answer to this is "no". While Title 12, U.S.C., Sec. 35, provides that by a certain vote and with the approval of the Comptroller of the Currency a state bank with the requisite capital may be converted into a national bank, yet such action would result in the creation of a new national bank whose stock would be acquired by the holding company in place of the stock of the state bank. This result is prohibited by Sec. 4 of the Bill which makes it unlawful for any holding company to acquire the capital stock of an insured bank.

It is submitted that if Sec.4 is retained in the Bill, there should be an exception to permit the following:

(a) The acquisition by a holding company of shares in a bank already controlled by it, whether such shares be now outstanding or are new shares.

(b) The conversion of a controlled state bank into a national

bank in accordance with the statute to that effect;
(c) The establishment of branches to take the place of the acquired, consolidated or converted bank and its branches.

7 - DOES THE DEFINITION "AFFILIATE" MAKE EACH BANK CONTROLLED, AN AFFILIATE OF EACH OTHER BANK CONTROLLED BY A HOLDING COMPANY?

This question must be answered "yes". Sec. 2(9) defines "affiliate" of an insured bank to include every other company controlled by the same holding company. One consequence of this comprehensive definition is to prohibit the purchase of securities from one affiliate by another. Consequently if a given corporation owns 10% of the stock of two separate banks, these banks are deemed to be affiliates and neither can extend credit to the other nor purchase securities from the other, regardless of the nature of such securities, and even though they are U.S.Government bonds. Furthermore, each of these banks would be subject to the provisions of Sec. 6 requiring every affiliate to file with every other bank with which it is an affiliate, the financial information therein required.

8 - SUPPOSE COMPANY "A" OWNS 10% OF THE STOCK OF COMPANY "B" AND COMPANY "B" OWNS 10% OF THE STOCK OF COMPANY "C", AND COMPANY "C" OWNS 10% OF THE STOCK OF AN INSURED BANK, ARE ALL OF THESE COMPANIES DEEMED TO BE HOLDING COMPANIES WITHIN THE MEANING OF THE ACT?

The answer to this question would seem to be "yes", even though Company"C" has only 1/10 of 1% of an interest in the stock of the bank in question. Thus, each of these companies would be subject to the provisions of the pending bill with respect to filing reports, detailed examination of assets, and prohibitions against acquiring any additional shares of any company in the above series in which it already held 10% of the stock. The definition of "control" is so far-reaching that it is difficult to envisage all of the possible consequences. Among the consequences is making it unlawful for any corporation to acquire more than 10% of the stock of any company which in turn has more than 10% of the stock of an insured bank. It is submitted that the foregoing observations call for a different definition of "control". It would seem that where ten companies have each 10% of the stock of another company, it is arbitrary to say that each of them is in control of the company in question. A sounder definition would appear to be the ownership of what in fact and in law constitutes control - namely the holding of a majority of the voting shares or voting rights. The latter is the theory of the present law relating to bank holding company affiliates - Title 12, U.S.C., Sec. 221a.

9 - IF IT BE ASSUMED THAT THE PUBLIC INTEREST REQUIRES SOME LIMITATION UPON THE EXPANSION OR DEVELOPMENT OF BANK HOLDING COMPANIES, WHAT LIMITATION MIGHT BE PROPOSED?

It is submitted that the restrictions and limitations proposed by the pending Bill are in many respects arbitrary and confiscatory. Many existing bank holding companies have sold their securities to the public, and in considering the future legal status of bank holding companies, consideration must be given to the following classes of people: (a) The depositors in the various controlled banks; (b) The competitive situation of controlled banks as compared with other banks within the same economic community; (c) The members of the public who in good faith have purchased stock in bank holding companies. In many cases, it is submitted that the depositors in a group of controlled banks are more strongly [illegible] than the depositors of individual banks in the same vicinity, this for

the reason that it is to the holding company's interest to protect each individual controlled bank and to supply capital when necessary. Consequently, there should be no restrictions which would diminish the incentive to furnish additional capital. Likewise there should be no restrictions which would prevent a controlled bank from acquiring the assets of a weaker bank in the same vicinity, and likewise, in the interest of the depositors of a bank which is a member of a group of controlled banks, the controlled bank should not be denied the privileges open to its competitors in the same vicinity. The restrictions of the pending Bill put such bank - and therefore its depositors - at considerable disadvantage. In the third place, the members of the public who in good faith have purchased stock of sound banking holding companies, should not have their investment impaired by undue restrictions aimed to freeze a holding company into its present position. In the banking world as well as elsewhere, companies cannot be held static. They either go forward or backward, and sound banking companies should be permitted to develop normally in the communities in which they are already operating.

No argument is here made against legislation which would prevent bank holding companies from expanding into new territories. It is submitted that new legislation to regulate bank holding companies to a greater extent than they already are regulated, should be directed against their expansion in new lines or in new territories, but without depriving them of the advantages of competition in the fields and territories in which they have heretofore pursued their lawful operations. In order to accomplish what is probably one of the chief objectives of the pending Bill - namely, prevention of undue expansion of holding companies and diminishing the incentive to form new companies - it is suggested that in lieu of the present measure, there be a restriction upon the amount of banking resources of a given state which may be controlled by bank holding companies, as for example, a limitation of 10%. Such limitation would prevent any bank holding company from controlling, through controlled banks, more than 10% of the banking resources of any given state. Itwould seem that if 90% of the banking resources are free from bank holding company control, it would not plausibly be charged that such companies have a position of dominance or undue influence in the banking field. Holding company control, however, in that case, should not be defined to include only 10% of the voting rights of a bank or of another holding company, as otherwise the proposed 10% limit on banking resources might be reduced to 1% or even much less. "Control" should be given a definition in harmony with the general usage of that term.