BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 27, 1950

To Mr. Eccles

Subject:

From Mr. Carpenter

In accordance with the understanding at the meeting yesterday, there is attached a copy of the revised statement containing comments upon the proposed substitute bank holding company bill which were agreed upon for transmission to Senator Robertson. A letter to Senator Robertson transmitting the memorandum is now being written and a copy will be delivered to your office as soon as it is available.

Attachment

COMMENTS UPON PROPOSED SUBSTITUTE BANK HOLDING COMPANY BILL
(COMMITTEE PRINT OF APRIL 22, 1950)

There are set forth below views and comments of the Board of Governors of the Federal Reserve System regarding the April 22, 1950 Confidential Committee Print of a proposed substitute for S. 2318, the bank holding company bill.

No Change in Existing Law

Proposal. - The proposed substitute bill does not repeal, modify, or change in any way the provisions of existing law relating to "holding company affiliates", but leaves these provisions intact in the law. It would superimpose its provisions upon the provisions of existing law.

Comment. - This treatment of the matter results in a shorter bill which, on its face, may appear to be relatively simple; but when the existing law and the substitute bill are considered together, interpretation of the resulting provisions is confusing, and the effort to achieve brevity and simplicity defeats its own end. There appears to have been some misapprehension as to the nature and effect of the proposed substitute bill. It should be clearly understood that the substitute bill is not an amendment to existing law. If it were enacted, it would result in two independent statutes relating generally to the same subject matter but not correlated in any manner. On the one

hand, there would be the existing law relating solely to "holding company affiliates" of member banks. On the other hand, there would be the new law relating to "bank holding companies". Some holding companies would be "holding company affiliates" under the existing law and subject to all its requirements and at the same time would be "bank holding companies" under the new law and subject to all its requirements. Other companies, however, would be "bank holding companies" but not "holding company affiliates" and, therefore, would be subject only to the new law. This would be true, for example, of a company like Morris Plan Corporation which controls only nonmember banks. Similarly, there are companies which control banks but are not "holding company affiliates" under the existing law because of exemptions granted by the Board but which would be "bank holding companies" under the new law and could not be exempted from the requirements of the new law. There is no justification for these distinctions and lack of uniformity in requirements or the confusion which would necessarily result from attempting to deal with this subject in this manner.

Definition of "Bank Holding Company"

Proposal. - The substitute bill would define a "bank holding company" in much the same way as the term "holding company affiliate" is defined in existing law, except that it would apply to the ownership or control of insured banks instead of only member banks. Thus, a company would be a holding company if it owns or controls 50 per cent

of the shares of a bank, or 50 per cent of the shares voted at the last election of directors, or controls in any manner the election of a majority of the directors. A company which, under this definition, is a bank holding company on April 15 or thereafter, would always be a holding company; and so long as it owns or controls more than 5 per cent of the shares of any insured bank, would be subject to the restrictions of the revised bill.

Comment. - One of the principal objections to the existing law is that the definition of "holding company affiliate" is not broad enough to reach some companies which control the management and policies of banks. Ownership or control of 50 per cent of the stock of a bank is entirely unrealistic as a basic test for determining whether a holding company relationship exists, because it is common knowledge that one company may exercise a controlling influence over another company without owning or controlling a majority of its stock. The continuation of this 50 per cent test of a bank holding company relationship would facilitate evasion of the law.

The test of a bank holding company based on "control in any manner" of the election of directors of a bank has very little practical meaning. In the first place, it is extremely difficult to prove such control, and no supervisory agency of the Government would be vested with any authority to make any determination in this regard. The question could be settled only by resort to the criminal courts through the Department of Justice. Of course, the law would be construed strictly

against the Government, as all criminal statutes are. Moreover, even though a company might be a bank holding company because of "control in any manner" of a bank, it would not be subject to the restrictions of the law unless it also owns or controls more than 5 per cent of the stock of some bank.

The Board believes, therefore, that the definition of "bank holding company" proposed in the substitute bill is impractical and will be unsatisfactory in accomplishing the desired results. The Board is of the view that, whatever percentage of ownership may be used, it is essential that any adequate definition of bank holding company also provide for some discretionary authority in the administering agency. Without such authority there will necessarily be some cases which should be covered by the law but which would not be brought within its provisions. For example, there is one important bank group where the stock of the banks is held by trustees under a testamentary trust, and it appears that the largest bank in the group may exercise a controlling influence over the management and policies of the other banks. There is, however, no effective means of providing in the statute a definition which would cover this institution unless it be done through the exercise of a discretionary authority after investigation and a hearing if necessary. If the bill included an adequate provision for authority to determine whether a particular company is a "bank holding company", the Board would not be inclined to regard the 50 per cent test as being entirely unworkable.

The definition in the substitute bill does not adequately cover cases in which a company exercises a controlling influence over a bank holding company and thus indirectly exercises such an influence over a group of banks. Thus, as is true in at least one case, a company might own slightly less than 50 per cent of the voting stock of a bank holding company controlling substantial banking interests, but would not itself be a bank holding company. Such a company would be free to purchase bank stock and to continue to hold nonbanking investments without regard to the restrictions contained in the substitute bill.

The definition of "bank holding company" in the substitute bill does not contain any provision for exemptions. It differs in this respect from existing law which, in defining "holding company affiliate", provides that that term shall not include, except for limited purposes, any company which the Board determines is not engaged as a business in managing or controlling banks. Through the years the Board has made such determinations with respect to over 150 organizations which controlled one or more banks but which the Board did not regard as being engaged as a business in managing or controlling banks. These organizations have included, among others, large industrial or commercial businesses, labor unions, churches, colleges, etc., which had incidental banking interests. In a large percentage of the cases, the control of only one bank was involved.

The fact that an organization might have been so exempted under the definition of "holding company affiliate" under existing law would have no bearing whatsoever on its status as a "bank holding company" under the proposed substitute bill. If it controlled a bank, the organization would be a "bank holding company" and required to divest itself of either its nonbanking interests or its bank stock. Aside from being an unnecessary irritant and nuisance as an administrative matter, the results might be quite unfortunate from the standpoint of the public interest in some instances where organizations own and operate banks as a matter of convenience for their members, employees or customers.

Diffusion of Administrative Responsibility

Proposal. - The substitute bill provides that a bank holding company, in order to acquire the shares of any bank must obtain the approval of the Board if the bank to be acquired is a State member bank, the Comptroller of the Currency if the bank is a national bank, and the FDIC if the bank is a nonmember bank.

Comment. - This diffusion of authority, the Board believes, is impractical, will lead to conflicting policies, and will hamper the effective administration of the law. As was stated during the hearings on S. 2318, the Board believes that from the standpoint of efficient administration and the fixing of responsibility, such authority should be vested in a single agency. However, if

this is not to be done, the Board believes that, rather than to have the authority diffused as proposed in the substitute bill, it would be preferable for the three Federal bank supervisory agencies to act as a unit and that unanimous approval of all three agencies be required for expansion by a holding company group. If provision were made for unanimous approval, it should be required for the establishment of branches and the purchase of assets of other banks by subsidiary banks in a bank holding company group, as well as for the purchase of bank stock by a bank holding company; and similarly all other administrative action provided for in the bill should be by unanimous agreement.

Expansion through Purchase of Assets

Proposal. - The substitute bill omits completely any provision requiring a banking subsidiary of a bank holding company, or a bank holding company which is itself a bank, to obtain the approval of any supervisory agency before purchasing the assets of any other banking institution.

Comment. - Expansion and tendency toward monopoly can be attained not only by the purchase of shares by a bank holding company but also by the acquisition of assets of other banking institutions by banks in a holding company group. It is true that, if after such a purchase of assets the holding company desires to convert the institution so acquired into a branch of one of the banks in the group, it would ordinarily have to obtain permission. No such permission is required, however, where the bank whose assets are taken over is not to be

replaced by a branch. The acquisition of assets of a bank, coupled with its liquidation, can be a very effective means of eliminating competition in a given community. The Board believes, therefore, that legislation for regulation of bank holding companies can be effective only if it includes restrictions on the purchase of assets of banks. It is noteworthy in this connection that the House of Representatives has passed, and a subcommittee of the Senate Judiciary Committee has approved, a bill to make certain provisions of the Clayton Act restricting stock purchases by corporations applicable also to purchases of assets of other corporations where the effect is a lessening of competition or tendency to monopoly. The purchase of assets of banks by banks controlled by a bank holding company should be permitted, in the Board's view, only with administrative approval granted after consideration of the same standards or guides as are prescribed in connection with the purchase of bank stock by holding companies.

Creation of New Bank Holding Companies

The substitute bill does not provide adequate control over the creation of new bank holding companies. As long as a company did not acquire a majority of the stock of any bank, it would be possible for it to acquire a very substantial portion of the stock of any number of banks and to exercise a controlling influence over a large bank group without being a bank holding company subject to the restrictions of the substitute bill. Also, it would be possible for a newly organized corporation to acquire all

of the stock of all of the banks controlled by two or more bank holding companies without approval by any supervisory agency; and by this means it would be possible to consolidate two or more holding company systems, thus permitting increased concentration of banking and consequent tendency to monopoly.

Regulation, Investigation, and Enforcement

Proposal. - There is no provision in the substitute bill for regulation or supervision by any Federal agency, and likewise no provision for the making of investigations. There is no sanction or provision for enforcement except criminal penalties. Willful violation of any provision of the bill would be subject to a maximum punishment of $1,000 a day in the case of a corporation or any other organization, and a maximum of $10,000 fine or one year imprisonment, or both, in the case of an individual.

Comment. - If the administration of the law is to be effective, it is imperative that there be appropriate authority for the making and enforcement of regulations by the administering agency. An authority to make investigations is necessary in order to determine what institutions may or may not be bank holding companies within the meaning of the definition prescribed and therefore subject to the restrictions imposed by the legislation. Without such authority to make investigations, institutions which should be regulated may be able to avoid the law entirely. Furthermore, without such authority, together with a power to require correction in appropriate cases, the affairs or conduct of bank holding companies which might be inimical to the public interest,

or possibly contrary to specific legal standards, could not be dealt with adequately. It seems obvious that a power of investigation, with appropriate subpoena power, should be vested in the appropriate agency of the Federal Government. In providing criminal sanctions alone, without provision for investigations and administrative hearings or other civil proceedings to decide questions with respectto which there may be honest differences of opinion, the proposed substitute bill would be punitive legislation of the most drastic kind. In urging appropriate provision for investigations and administrative hearings, the Board is merely suggesting procedures comparable to those long followed by the Federal Trade Commission, Securities and Exchange Commission, Interstate Commerce Commission, and other regulatory agencies. In connection with sanctions, it is believed that, in addition to criminal penalties, consideration should be given to less drastic penalties such as were proposed in S. 2318.

Examinations of Bank Holding Companies

Although existing law authorizes examinations of bank holding companies where member banks are involved and applications are made for voting permits, the substitute bill contains no provisions with respect to examinations. Accordingly, a holding company, such as Morris Plan Corporation, which controls only nonmember banks would not be subject to examination by any Federal agency. Obviously, there should be an appropriate provision for examination of all bank holding companies.

Judicial Review

There is no judicial review provided in the substitute bill, so that when a supervisory agency acts upon a request of a bank holding company for acquisition of shares and denies it, the decision is final. The Administrative Procedure Act does not help, because the latter does not prescribe judicial review in case of discretionary action. Consequently, a holding company would have no choice but either to accept the position of the supervisory agency or to be prosecuted criminally, with the virtual certainty of being convicted.

Divestment of Nonbanking Shares and Obligations

Proposal. - Under the substitute bill, a bank holding company would be prohibited, after five years from the date of the law, from holding stock in any nonbanking corporations, except those engaged in a safe deposit or a fiduciary business, and from holding any obligations except investment securities which national banks are permitted to purchase under the National Bank Act; but these provisions do not apply to bank holding companies which are themselves banks or trust companies.

Comment. - The substitute bill contains no exception to this provision which would permit the ownership of 5 per cent or less of the securities of any one company. Such an exception, the Board believes, is a justifiable one because it permits a bank holding company to continue to have diversified investments where the amount of each such investment is so small that it does not contravene the

basic objective of the bill. In this connection, it should be noted that under provisions of existing law which would still be applicable to any holding company which held a voting permit, a holding company is required to build up certain reserves of readily marketable assets; these assets now may consist of readily marketable stocks, as well as bonds, and there appears to be no good reason why this should not continue to be permitted. The substitute bill apparently does not permit a bank holding company to own assets which it has acquired from a subsidiary bank in a case where the bank has been asked by the appropriate supervisory authorities to rid itself of certain undesirable assets. Also, under the substitute bill it is not clear that a bank holding company could own a corporation organized for the purpose of providing bank premises. These would all seem to be desirable exceptions to the restrictions on holding of nonbanking investments. In addition, there are other business enterprises which are closely related to banking and whose association with banks has been traditionally recognized as being unobjectionable, so that their control by bank holding companies would seem to be likewise unobjectionable.

Standards

Proposal. - In passing upon requests for bank holding companies to purchase shares in banks under the proposed bill, the appropriate Federal supervisory agency would be required to take into consideration the financial condition of the bank, adequacy of capital, earnings prospects, character of management, needs of the community, and whether or not the corporate powers are consistent with the law

relating to Federal insurance of deposits. It would also be required to take into account the policy of Congress "in favor of local ownership and control of banks and competition in the field of banking". It is apparently intended that the various factors enumerated above would have to be taken into consideration also by a Federal supervisory agency in considering applications for branches.

Comment. - The Board has no objection to this requirement and feels that it is a desirable and constructive one. It is very important, however, that it be made entirely clear that these standards are to be taken into consideration in passing upon applications by banks in a holding company group for establishment of branches and purchases of assets of other banks.

Voting Permit Procedure

The principal requirement of the existing law is that a holding company must obtain a voting permit from the Board if it wishes to vote the stock which it owns in a member bank. As has been previously pointed out, this provision is impracticable because it leaves with the company the option as to whether to obtain a voting permit, and the law is not applicable to a company unless it chooses to get such a voting permit. It is sometimes possible for a company to operate satisfactorily and to control its banks without a voting permit. This unsatisfactory procedure is left unchanged by the substitute bill. It seems most important that the voting permit procedure be eliminated and that all of the requirements of the law, whether new or old, be made uniformly applicable to all bank holding companies.

Miscellaneous Subjects Not Covered

In addition to the comments made above, it should be noted that the substitute bill does not contain any provisions to restrict loans made to a bank holding company by a subsidiary nonmember insured bank; any provisions requiring a bank holding company to maintain a reserve of readily marketable assets where member banks are not involved and voting permits are not obtained; any provisions providing regulatory control by a supervisory agency over the charging of excessive management or service fees by holding companies against their subsidiary banks; or any provisions for registration of holding companies or the making of reports by them.