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Remarks of

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SOME THOUGHTS ABOUT THE IMPLICATIONS FOR BANKING OF THE AMENDED BANK HOLDING COMPANY ACT

Inasmuch as many of you serve as counsel for banks and other financial institutions, I thought I might offer to you some thoughts about the implications for banking and, of necessity, the bank lawyer that resulted from the 1970 amendments to the Bank Holding Company Act. These changes in banking law created, I believe, the framework for a whole new world for bankers and bank counsel to live in, and the possibility for a whole new, and better, relationship of banking to the public it serves.

This new world is filled with opportunities disguised as problems, and problems disguised as opportunities, for both banking and the public. What I am saying is based on my experience as a banker and bank lawyer and my impressions as a regulator administering the new legislation since joining the Federal Reserve Board in June of last year.

From New Restraints to New Opportunities

When the Congress set out in the late 1960's to amend the Bank Holding Company Act, the principal impulse was the fact that an exemption in the original 1956 Act had turned out to be a serious loophole. As you are well aware, the 1956 statute applied only to holding companies owning more than one bank. A bank holding company with only one bank could acquire nonbank businesses very much as it

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pleased, without need to register as a bank holding company and with no obligation to be bound by the limitations on nonbanking activities applying to multibank holding companies.

It seemed to certain members of Congress and others that the rush to the one-bank holding company format in the closing years of the 1960's could lead to the undoing of the American tradition that commerce and finance are economic forces that can and should be required to deal at arm's length with one another, so as to avoid the concentrations of power that produced the zaibatsu one ocean away on one side of us, and the cartel across another. Some might have conjured visions of the multibillion dollar United States banks converting themselves to one-bank holding companies and acquiring -- or being acquired by -- multibillion dollar industrial giants. I doubt very much that the sensible businessmen who run our largest businesses would have had the bad judgment to fly so directly in the face of American tradition -- of which they are a part -- and laws against monopoly power, but the legal situation did not foreclose it. But even without such ultimate spectaculars, competition for market position was bound to bring about combinations of bank and nonbank holdings that would be increasingly large, and increasingly uncomfortable, unless the legal situation permitting it were amended.

Following a study of the problems presented by the trend toward formations of one-bank holding companies, the Federal Reserve on February 20, 1969, issued a "Statement of Principles" expressing

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the Board's belief that an end to the one-bank exemption was essential. The statement noted the "recent trend in the formation of one-bank holding companies" and the facts that "the unique characteristics of banks led the Congress in 1933 to separate banking from non-banking business, and in 1956 to reinforce that policy by limiting the activities of multibank holding companies to the management and control of banks and closely related activities."

The Board's statement stressed that this separation should be maintained. To that end, it made two basic recommendations:

> "1. The Board believes that it is essential that one-bank holding companies be included within the purview of the Act.
>
> "2. The Board considers that under present circumstances the law should not permit a bank to become a part of a conglomerate organization."

Thus, as suggested by the Board's Statement of Principles, the 1970 Amendments to the Bank Holding Company Act were born in apprehension that the wall separating the financing of production from the business of producing goods or services was crumbling, and that new restrictions should be enacted to make that wall intact again.

But the Board's statement added something else, as it turned out, quite significantly:

> "(The Board) also believes, however, that, consistent with continued growth and development of a dynamic and increasingly complex economy, banks should be granted freedom to innovate new services and procedures, either directly, or through wholly-owned subsidiaries, or through affiliates in a holding company system, subject to administrative approval of entry and acquisitions. . . ."

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Further on in its statement -- which contained many points that I am not touching on here -- the Board indicated the parameters it would have in mind in administering such greater freedom for banks to innovate new services and procedures:

> ". . .In determining whether a particular activity by bank holding company organizations is consistent with the public interest, consideration must be given to whether the benefits of such affiliation outweigh the potential dangers at which separation of banking from nonbanking businesses has been directed. Such benefits would include greater convenience to the public, increased competition, and gains in efficiency for the economy generally as well as for the holding company organization. The potential dangers. . . are undue concentration of resources, decreased competition, conflicts of interest leading to less equality in the availability of credit, and dangers to the soundness of the nation's banking business."

The Amendments to the Bank Holding Company Act signed into law at the end of 1970 reflected, by and large, the Board's formulation of the nature and need for new banking legislation to bring the one-bank holding company into the regulatory fold. Thus -- and this is one of the main points I want to make -- the new legislation, born in apprehension and a spirit of constraint, while meeting misgivings by putting all but certain grandfathered one-bank holding companies under the same regulatory constraints as apply to multibank holding companies, went much further. It rewrote the constraints.

This was not done without much agonizing in the Congress over the extent -- if any -- to which the amended bank holding company law gave greater freedom for bank holding companies to acquire non-banking

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businesses. In the end, the Congress left it to the Board to interpret as well as implement the new legislation. The Board by its actions has indicated that it can only interpret the words approved by the Congress as providing greater scope for bank holding companies to make non-bank acquisitions than they had under the old Act. But, at the same time, the Board has very considerably qualified the use of that greater scope by the emphasis it has placed upon the tests of public benefit implied or stated in the new Act. Thus, it has been and is the view of the Board, as demonstrated in its implementation of the new legislation, that any acquisition -- however comfortably within the strictly legal confines of the new reservation -- must also be within the public benefit tests before it can be approved. The result, as I see it, is much greater freedom for banking to innovate, balanced off against strong emphasis upon how that freedom may be used.

The point here is that no one can take the new Act and run wild with it, without reference to whether an intended acquisition might create an undue concentration of resources, weaken competition, ride down conflicts of interest or erode the soundness of the nation's banking system. That is true, fundamental and important. I think it is also probably generally understood. I believe the Board stands ready to emphasize that understanding whenever there is need to do so.

In general, the problem disguised as an opportunity posed for bank management by the new Act lies in the fact that the new legislation may well lead banking out of the routine of making the major portion

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of its profits chiefly from the spread between the cost of acquiring and the price of lending money.

Saying it another way, your client finds himself governed by legislation which provides him with the opportunity to achieve a better balanced business mix, yielding a more dependable profits curve, than the ups and downs traditional to banking. In the process, banking as an institution will have an opportunity to escape, in the public eye, from the image of the money lender pure and simple, and take on, instead, a new image, of a service-oriented center for a variety of financial and finance-related services, capable of giving increased support, in a more competitive setting, to the consumers, businesses and communities served by banks in a bank holding company. This opportunity, of course, carries with it a real challenge to the banking legal fraternity -- which challenge many of you have undoubtedly already found.

". . . that divides the
desert from the sown. . ."

Omar Khayam sang of the delights of those places where the desert ends and the green begins. Being a poet, he declared himself satisfied with a jug of wine, a loaf of bread and a pretty girl beside him. He knew nothing, or at least did not care to write about, the problems of economic development involved in having available even his simple requirements.

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As background to the rest of my remarks, I want to pause briefly to mark the desert from the sown; that is, the permitted and the unpermitted under the new bank holding company law. But, being no poet, I cannot promise to confine myself only to delights and to ignore the problems implied.

First, although I am well aware that some of you can recite the list by heart, I will briefly touch on the activities or classes of activities presently available to a bank holding company under the 1970 Amendments to the Bank Holding Company Act:

--Lending, such as done by a mortgage, finance, credit card or factoring company.

--Consumer loan banks -- an industrial bank, Morris Plan Bank or industrial loan company -- operating in accordance with state law.

--Servicing loans or other extensions of credit for any person.

--Trust functions.

--Acting as investment or financial adviser.

--Leasing of personal property so long as the lease is expected to provide a full payout. Comparable treatment with respect to real property leases has recently been the subject of a published proposal.

--Making either equity or debt investments designed primarily to promote community welfare, such as development of low-income areas.

--Providing bookkeeping or data processing services for the internal operations of a holding company and its subsidiaries, and other data processing of a financial, banking or related nature.

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--Acting as insurance agent or broker in offices at which the holding company or its subsidiaries are otherwise engaged in business, or in an adjacent office.

--Management of property held by the bank holding company or its subsidiaries, for conducting its own bank and related operations, or property held in a fiduciary capacity.

--Underwriting credit life, health and accident insurance.

--Acquisition of businesses not included in the Board's approval list, when the applicant demonstrates that the acquisition is necessary to permit it to more readily market assets subject to divestiture.

This, in brief, is the sown: the presently defined area in which banking can innovate new services. But let me add two cautions. First, it is no more than a summary. I have not attempted to convey the fine print. You, of course, are in a position to advise yourselves of provisos affecting most of these decisions. Further, announcement of a "permissible" activity does not, of course, make it automatically available. It must be applied for, and must pass the tests of public benefit that I previously stressed. An activity may be generally permissible, but not available, for instance, in the particular setting of a banking market, or in the non-bank competitive setting it would affect.

What of the desert? I will not take time to list in detail those activities that the Board has turned down. In interpretations published in the Federal Register in April and September of this year, the Board listed the following as not being, in the Board's

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opinion, so closely related to banking or managing or controlling banks as to be a proper incident thereto:

- --Equity funding (later changed, without change in substance, to Insurance Premium Funding);
- --Real estate brokerage;
- --Land development;
- --Real estate syndication;
- --Management consulting;
- --Property management, and
- --Operation of savings and loan associations, at least for the present.

As with permissible activities, I have given only a summary, and there is a fine print to consider. As for applicability, anyone is free to apply for an activity that has been declared non-permissible, but the applicant must be prepared to present facts and arguments not considered earlier by the Board. Further, anyone may apply to engage in an activity of a type that has not been ruled upon either way.

Some Effects of the 1970 Amendments

A table in the August 1972, Federal Reserve Bulletin revealed some quantitative effects of the 1970 Amendments to the Bank Holding Company Act. It showed, as of June 30, 1972 -- and much more has been added since -- that there were bank holding companies in 50 states and the District of Columbia. The total number of companies was 1,601, and they held 2,571 banks and 12,279 branches. This was nearly 40 per

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cent of all commercial banks in the United States. Furthermore, banks in bank holding companies at mid-1972 held over 58 per cent of all deposits in United States banks, and just over 60 per cent of all United States bank assets.

At the end of 1970 -- just before the new legislation went into effect -- there were 121 registered multibank holding companies in the United States, holding 895 banks and 3,260 branches. They held 12 per cent of all bank offices in the United States and 16 per cent of all deposits.

Another way of measuring the effect is the impact on the System's workload: In the five years before the 1970 amendments went into effect, the System passed upon an average of 69 bank holding company cases a year. In 1971 -- the first year of the new legislation -- the Board acted on 234 bank holding company applications. In 1972, we processed some 500 cases. We estimate that the number will be over 800 in 1973.

These figures indicate that the new bank holding company legislation has permanently affected financial structure in the United States. There is no slackening in the number of applications for the formation or expansion of bank holding companies coming to the Board. I conclude that we as yet have no evidence that the attraction of this form of banking structure has run its course, and that there is no reason, as yet, to believe that the portion of American banking that is now in bank holding company groups will not be substantially larger in the future than it is now.

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That being the case, it is well to take a look at some of the problems disguised as opportunities and some of the opportunities disguised as problems, in the bank holding company formulation; that is, some benefits and some cautions.

Some
Cautions

Let me take up first the main reasons for caution that I see, and then discuss the benefits to banking, and to the public it serves, that ought to flow from the new bank holding company law.

All of the cautions I have in mind might be stated in one general way: the enlarged scope permitted by the 1970 amendments for banking to affiliate itself with nonbanking business involves a single comprehensive danger: bankers will be dealing with businesses that -- even though closely related to banking -- are in fact significantly different from banking in important respects, and that, therefore, open prospects for substantial management errors.

Every banker considering forming, or becoming the financial center, of a bank holding company, should keep this danger foremost in mind. Similarly, the executive of a nonbank company considering acquiring a bank should be equally wary, for banking is a highly specialized business that only banking experts can run.

What this suggests, I think, is that after legal hurdles regarding structure have been overcome, the key to successful bank holding company operation lies in very careful consideration of management problems. Some banks may be run by men of such instinctive

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entrepreneurial skill that they can take on the widely differing managerial problems of some or all of the bank-related businesses already approved by the Federal Reserve Board. But such skill is rare. In most cases, bankers will have to depend upon management other than their own, when they affiliate with their bank -- say -- a data processing, or a factoring, or a leasing company, or all of these and more.

The difficulty here does not end when you find a well-run company that you can bring into your bank holding company. Generally, the company will have been a medium to small organization, managed by men accustomed to making the final decisions, and accustomed to making those decisions upon the relatively narrow basis of the ins and outs of their particular business. As a subsidiary of a bank holding company, even given the maximum autonomy prudently permissible, they will no longer have the final say. Further, their decisions will have to be placed in the broader context of the well-being of the holding company as a whole. For example, a data processing company may have to provide services in profitable, but less than optimum lots, in terms of profits, as part of a service package offered by the holding company. Very often, excellent management brought into a holding company by acquisition will soon exit because it cannot accommodate itself to such a management environment. Thus, in considering a nonbank affiliation, bank management must have it in mind -- even when acquiring management that is known to be skillful -- that the new affiliate may

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have to go through a fairly extensive period of management development before it becomes a solid member of the holding company's team, yielding fully the profits it is capable of making as part of that team and making the team as a whole more profitable.

While the management problem can be touchy in the case of an acquisition that has familiar and good management, it is obvious that the problem is all the more critical where an acquisition involves taking over management that is not familiar to the chief executives of the holding company, and particularly where lack of personal knowledge is combined with lack of a seasoned record of performance against which the ability of the intended affiliates' management can be judged.

Finally, management must always have in mind the question, when contemplating a nonbank acquisition, whether the holding company -- as distinct from its bank subsidiaries -- has the capital resources to get through a period of management development when the new affiliate's profits may be low or even negative. This is one reason the Board is concerned about the capital structure involved in holding company formations, and in the capitalization of holding company subsidiaries, bank or nonbank.

These are the central and pervading problems wrapped in the bright bindings of bank holding company potentials. Let me mention just one other rather general reason for caution. This is the fact that most of the nonbank businesses permissible to bank holding companies are

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service businesses, and service companies generally make their profits from fees. Banks, on the other hand, although they too are a service business, are accustomed to making their profits mainly from the spread between the cost of acquiring money and the price they can charge for money when they lend it or invest it.

Many bankers, perhaps most, will find themselves uneasy trying to shift their thinking to a fee basis, because this will require them, perhaps for the first time in their business career, to go through a careful costing process. The fee must cover costs -- all real costs -- and a profit. Here, bank holding company management must ask itself if it has the flexibility of mind, the inclination to change -- and the willingness to risk its success -- upon its ability to cost out the services it will be providing, and place competitive and profitable fee prices upon them. In this case, as in the more general management problem already noted, it may be necessary for them to take into their calculations a rather lengthy learning period, when the holding company's financial resources must be adequate to get through a time of management development that could be slow and costly.

Some Benefits

You may ask, why should all these bankers, your clients, take the plunge?

The answer, I think, lies about half in the fact that technology has its own dynamics, and brings about change that can be resisted,

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for the most part, only by the few and the special. We have assembly line production because the technology for such production became available. We have the dial telephone because the technology for such electronic programming became available. The other half of the answer, I think, is that new technology has a way of coming into being when there is a need, or a desire, for it. Printing was developed about when enough people able to read were present to make it a practical industry. The automobile came along when population growth and other demand and technical factors made the horse obsolete. There is a picture of Herbert Hoover watching the election returns that made him President on a tiny television set. But radio had not yet peaked and the depression of the Thirties discouraged introduction of new big ticket items. After the war of the Forties, and after radar demonstrated to all, in that war, the practicality of the electronic image, the already existing television technology came quickly into general use.

I believe that a combination of electronic bookkeeping abilities, high capacity communications technology, new management methods and public needs and desires is behind the spread of the bank holding company. It is not just that we <u>want</u> to bank differently from our grandfathers. It is also that we <u>need</u> to bank differently from our grandfathers. The population our banking system serves is so much larger. So many more people make so many more, and more complex, transactions. Needs for financing of businesses and households are larger, based on larger gross national product and family

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incomes. The credit card is with us as a financing instrument competing with traditional banking. The public is aware of the speed and efficiency that can be wrung out of the computer, and -- despite widespread run-in troubles with computerization -- the public wants this efficiency and hold-down of costs in banking as elsewhere.

For these and numerous other reasons that both make possible, and require, modernization of our financial service system, I think the bank holding company format is here to stay, and will be a very general phenomenon henceforward. I have been stating some of the main risks involved, as I see them, not to drive anyone off the bank holding company path, but to emphasize that the path is winding and narrow, and that it should be undertaken only by the wary, with prudence and good counsel.

Winding and narrow it may be, but it leads for those who have the skill and judgment to traverse it, to higher ground for banking, in terms of service to the public and in terms of sound and profitable banking.

The public's gain, as I see it, lies chiefly in two areas. One is increased competition. The Federal Reserve Board noted in its early Statement of Principles that de novo firms established by bank holding companies would generally be assumed to increase competition, by increasing outlets and service points, and the Board has given a boost to this form of increased competition by procedures for the approval of de novo affiliates of bank holding companies that are

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quicker and easier than for acquisitions of existing companies. In general, the Board has made pro-competitiveness a very major factor in approving or disapproving applications for bank holding company acquisitions.

The other main area of public gain lies in the efficiency and cost reduction available through computerized bookkeeping and other data handling, and the related packaging of services. So long as the Act's strict anti-tie-in provisions are honored, a bank holding company with a data processing subsidiary, for instance, can operate a computer of sufficient capacity to provide bookkeeping, payroll and like services to a large number of individuals and businesses. And -- again remembering that tie-ins are not permitted -- it can offer these services individually, or it can package them with related services, such as, for example, factoring, tax accounting, financial advice and leasing. Each of these services, when part of a package, can be made available at less cost than the price at which it could be provided separately. And, of course, offered as a package, there is a public gain in convenience similar to the convenience of the supermarket as compared to the grocery store, the notions store, the dairy store, the ice-house, the spice store and the other special outlets that once had to be visited separately to buy what is now available under one roof.

I have already indicated one of the chief benefits to banking. This is, getting off the traditional roller coaster of profit ups and

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downs and getting on -- through the operation of an efficient mix of banking and bank-related services that can be packaged -- to a steadier profit line.

I have also already mentioned the shift toward the earning of fees, and away from dependence upon the spread between the cost of acquiring funds and the price of providing funds, as the main source of banking profits. I brought this up earlier as a difficult passage for bankers to negotiate. I bring it up here as a substantial benefit to banking, once the problem of making the change has been successfully accomplished. As I noted, most of the non-bank affiliates of a bank holding company will be service companies earning fees. The benefit to banking lies in the fact that charging fees requires accurate costing of services. I suspect that few banks today -- operating chiefly on money's cost/price spread -- have an accurate idea of the cost of the services they provide to the public, and, consequently, do not know as precisely as they might why they make or lose money.

Let me mention one other general advantage of a technical nature. This relates to management, about which I have up to now been cautionary. Once the learning cruise has been completed, and a dependable and committed bank holding company complex of management is in place, there are substantial management advantages to be gained, by better development and use of management skills. These skills can be teamed where they are complementary. Managers can be moved, both laterally and vertically, as experience and abilities increase, and

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in step with the holding company's program for developing replacement management at the top. Until the very top levels of holding company management are reached, there is no narrowing command pyramid to impede management transfers, such as there is in one separate company. I think, consequently, that the diverse banking and related services that can now be brought together under the bank holding company umbrella will make for the development not just of better management, but also of better bank management. It will bring into the upper levels of banking men who are widely acquainted with a substantial range of the businesses, other than banking, that banking must finance.

Finally, let me come back to a thought that I expressed early in my remarks. That is, if the bank holding company develops as it should, as an instrument that improves the technical performance of banking services, holds down the cost of those services, provides the public with a supermarket of financial and related services at lower cost than would otherwise be the case, and makes for more competition in many lines of banking and related businesses, the public will not only be well served but, I think, will be well pleased. The story about the banker with one glass eye -- that being the one with the kindly glint -- will become a bit of history. Its place should be taken by a public view of banking as a wide-ranging industry that makes life more convenient and less expensive, for people, for the businesses where they earn their living and for their communities.

And you my friends of the legal fraternity can take pride in being a part of that development.

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