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THE PROBLEM OF IDENTITY

Remarks of

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## THE PROBLEM OF IDENTITY

The inability of Beverly Hills Bancorp to meet maturing commercial paper issues, announced at the end of last year, provided an unsettling beginning of 1974 for the U.S. banking community. Fortunately, this bank holding company's only bank was sold to a large California organization, and no serious damage seems to have been done to the banking system. But the events in Beverly Hills provide food for thought about a problem that has been on people's minds for some time.

Beverly Hills Bancorp had \$13.6 million of commercial paper outstanding--most of it had been sold in small lots to several hundred local investors. A substantial portion of the proceeds had been loaned to a southern California real estate developer whose operation developed cash flow problems from stagnant sales. On December 30, Beverly Hills Bancorp announced that, as a result of the inability of the developer to pay down its approximately \$7 million indebtedness to the holding company in a timely fashion, the holding company was unable to roll-over its commercial paper.

Although it was not directly involved, the holding company's subsidiary bank suffered a deposit loss of over \$20 million (more than 15 per cent) due, apparently, to an identification in the minds of at least some depositors of the holding company's problems with those of its banking subsidiary. However, the bank's capital was protected by the Comptroller of the Currency's cease and desist order.

Use of the Federal Reserve discount window helped the bank to survive its liquidity crisis. Notwithstanding this substantial deposit drain, and attendant confusion and lawsuits, the bank was sold to the Wells Fargo Bank and there has not been loss to any depositors. Wells Fargo purchased most of the assets and assumed substantially all of the liabilities of the bank.

The problem pushed so strikingly into the headlines by this case can be summed up in three questions--what is a bank, what is a holding company, and what is the difference between the two? As the Beverly Hills case illustrates, there is an identification problem, at least in the minds of the public and the press. But also, I fear, there is a related problem in the minds of the bank holding companies themselves. As the principal regulator of bank holding companies, the Federal Reserve must cope with this problem, and I'd like to share my thoughts about it with you today.

I want to make it clear that, in outlining my own thoughts on these matters, I am speaking for myself, and not for my colleagues on the Board. Further, my remarks should not be construed as a comment upon or the expression of an opinion about any controversy or pending litigation on these matters.

To begin, it is imperative to recognize that banks and bank holding companies are, in legal terms, very different things. Commercial banks are institutions chartered, either by the states or by the Comptroller of the Currency, to accept demand and time deposits and to make

loans and investments. Nearly all commercial banks are members of the FDIC, and all are examined periodically by at least one state or Federal agency. All national banks, nearly all of the larger State-chartered banks, and a good portion of the smaller State banks are members of the Federal Reserve System, and hence have direct access to the System's discount window.

For much of its history, this country had a banking system that tended to break down in periods of stress. The massive collapse of the 1930's, however, led to reforms that we all hope have come close to making the nation's banking system substantially fail safe. There have been, as you know, very few bank failures since the 1930's; few involved any substantial losses to depositors.

The American system of banking law and regulation seems clearly to rest on the notion that the public has a right to expect its deposits to be safe. FDIC insurance protects deposits up to \$20,000. But beyond this, relatively few holders of larger deposits take great pains to analyze the strength of the institutions into which they put their money, evidently feeling that the supervisory and regulatory system provides sufficient safeguards.

A bank holding company is very different from a bank. It is defined, under Federal statute, as a company that owns or controls one or more commercial banks. A bank holding company cannot accept deposits unless it is, itself, a bank nor are its creditors provided the status of deposit holders, including the benefits of FDIC insurance. Bank holding companies may engage in certain types of

nonbanking activities, either directly, or through nonbanking subsidiaries. But neither bank holding companies nor their nonbanking subsidiaries are eligible for loans and advances from the Federal Reserve System, except under extraordinary circumstances involving a clear threat to the public interest.

In thinking about the identity problem, the foremost thing to keep in mind, I believe, is the very real legal difference between a bank and a bank holding company. The fact that there is an identity problem, despite the clear legal difference, is rooted in the history of the bank holding company movement.

The multibank holding companies that emerged in the 1920's and 1930's, and flowered again in the 1950's, were by and large "bank-oriented." These multibank holding companies, most of which had a relatively large lead bank, provided a more efficient way to raise capital and to manage strings of smaller subsidiary banks. In some ways, a multibank holding company could be thought of as a big "bank."

The financial congeneric one-bank holding companies that flourished in the late 1960's were organized principally to get around restrictions on the scope of activities of commercial banks. But they also provided access to the commercial paper market when Regulation Q ceilings and tight money combined to put a squeeze on large banks which depended heavily on the CD market for short-term funds.

Even today, after several years of development, most diversified bank holding companies tend to be so dominated by their banking subsidiaries that it is tempting to think of the holding companies and their nonbanking subsidiaries as appendages of subsidiary banks. And it is noteworthy that, in the deliberations leading up to the passage of the Bank Holding Company Act Amendments of 1970, Congress focused part of its attention on what may loosely be termed "antitrust considerations"--i.e. the prevention of monopolization and undue concentration of power--together with a preservation of the separation of banking from commerce that is part of the American tradition.

It should not, then, be too surprising that there has tended to be a blurring of the distinction between banks and bank holding companies in the minds of the public, the press and even the managements of these companies themselves. The Beverly Hills case makes it even more apparent that an effort must be made to deal with the present identification problem.

Let me now put forth my basic proposition. I believe that it is imperative to turn our attention to this matter of identification. This question is of interest to both regulators and the banking industry since there is no inherent reason why the bank holding company movement must lead to a deterioration of strength of the American banking system. This could happen under certain circumstances, but the movement can also strengthen the banking system and make it more vital and responsive

to the needs of society. The latter is what I am sure Congress intended, and we--the banking system and its regulators--have the responsibility to make sure that the public interest is served.

The major potential dangers to the soundness of the banking system raised by the bank holding company movement fall into two broad classes: first, the potential for unsound relationships between banks and their holding company or the other holding company nonbank affiliates; and, second, possible confusion in the minds of the public over the distinction between a bank and a bank holding company.

The possibility of unsound relationships between banks and their parent holding companies concerns regulators. There are many situations in which transactions between bank and nonbank portions of the holding company make good business sense to a management with its eye on profit maximization; however, these transactions may weaken subsidiary banks. Such possibilities are not, of course, unique to the holding company movement. The difficulties of the United States National Bank in San Diego resulted largely from loans to companies with common ownership which were not directly related within a bank holding company. But the diversified holding company almost by definition raises the issue.

There seem to be five major categories of transactions with affiliates that could weaken holding company banks: (1) excessive upstream dividends, (2) excessive management fees and other charges

for services of affiliates, (3) loans to the holding company or other affiliates, (4) transfer of profitable operations or assets from banks to other affiliates, or transfers of unprofitable operations or assets from other affiliates to banks, and (5) inappropriate prepayment of debt owed to the holding company by subsidiary banks.

Federal banking law already provides some protection: national banks and State member banks are required to obtain approval from the regulatory authorities before paying dividends in excess of net income for the current year and retained earnings of the two previous years. Loans to affiliates, including parent holding companies and their nonbanking subsidiaries, are restricted as to amount, and required to be fully collateralized for all insured banks. Furthermore, all of these potential threats to the soundness of all insured banks are subject to cease and desist orders when "unsafe or unsound practices" are detected through the bank examination process. Still, as I shall indicate later, I believe that we should work toward further safeguards in this field.

The other major problem area--potential public confusion between banks and bank holding companies--could present even greater difficulties if it is not handled properly.

For one thing, such confusion may inhibit the private capital markets in performing their "policing" function. Generally, the



U.S. financial system relies heavily on the workings of the private markets for both debt and equity to limit business risk taking. However, the private market may not be sufficiently vigilant in limiting borrowing by bank holding companies. Perhaps this is due to a mistaken belief that the holding company has direct access to the resources of its subsidiary banks, or perhaps lenders believe that regulators will intervene to protect creditors of bank holding companies much in the same manner in which bank depositors are protected. The Beverly Hills case illustrates that regulators are primarily concerned with the safety and soundness of banks, as in my view, they should be.

In addition to the possibly inadequate vigilance of private interests in holding company obligations, there is a very real danger that bank depositors and the public at large may equate problems in a bank holding company with problems in a subsidiary bank. Lack of knowledge of the safeguards that limit the use of bank resources by its parent can lead to actions which do undermine the bank, as happened in the case of Beverly Hills National Bank. This public confidence problem would, of course, occur more frequently if the private market fails to adequately police the operations of parent holding companies.

There is, of course, some short-run benefit to bank holding companies to be gained from taking advantage of a confusion of identities. The major one is possible favored treatment as compared to

other industries in the credit markets. However, both the banking regulators and responsible bankers recognize the folly of that course in the long run. Surely if a confusion of identities becomes commonplace, one day a major disaster may well undermine confidence in the banking system. At that time, the regulators or the Congress could be expected to respond strongly, possibly in such a way as to sap the vitality of the bank holding company movement. This would work to the detriment not only of individual holding companies but of the public interest as well.

It is no secret that the Federal Reserve System has been working diligently for some time on the kinds of problems I have been discussing. This effort initially consisted of informal contacts with representatives of the financial community and analytical staff work.

Then, beginning in August 1973, the staff began to hold extended meetings with three different groups of outside consultants. The first consultant group consisted of certified public accountants, representatives of rating agencies, financial analysts, and investment bankers; the second was made up of bank holding company executives; and the third included practicing lawyers, academic experts, and executives of nonbank financial institutions. These consultant meetings proved invaluable, both to the staff and the Board, which was informed in detail of the consultants' recommendations, as well as those of the staff. Needless to say, there was not unanimity as

to how problems of the kind I have been discussing should be treated, but I think it is fair to say that the Board has been given a firm basis on which to proceed.

In a paper prepared for the use of the consultant groups, the staff outlined in general terms three broad approaches. I would like to use these as a basis for my remaining remarks.

First, it might be possible to supervise and regulate bank holding companies in a manner similar to banks. Such an approach would entail regular examinations of nonbank affiliates, relatively frequent and detailed reports from them, and little reliance on the technical legal separateness of banks from their nonbank affiliates.

The main advantage of close supervision of all aspects of holding company operations is that, successfully implemented, it minimizes the risk of holding company failures, thereby protecting subsidiary banks from difficulties originating in affiliates, assuring that parent companies will be strong enough to assist their subsidiary banks if required.

The potential problems that would result from bank-like supervision are numerous. First, the judgment of the regulatory authority would be substituted, to some extent, for that of management. These constraints probably would result in some loss of the flexibility that is needed to operate profitably and efficiently in nonbanking areas. Second, we could expect that in such an environment private market forces would provide only minimal restraint on

the finances of bank holding companies, since it would no doubt be assumed that bank-like supervision implied something approaching a government guarantee of holding company obligations.

In addition, even assuming the best, such an approach would be very expensive to implement, requiring a very large staff knowledgeable in the various businesses in which bank holding companies may engage. But it is a mistake to assume the best in matters like these, and the possibility must be recognized that the regulatory system might not be equal for some time to the task of closely supervising the varied and complex nonbank activities of bank holding companies. If it is not, failure of a very large bank holding company, or a string of failures of smaller organizations, could lead to a loss of confidence in their banking subsidiaries and the banking system generally, because of the inevitable close identification problem that would result from this approach.

At the opposite extreme would be a regulatory approach that relied entirely on the corporate separateness of banks from their nonbank affiliates to handle the identification problem. Regulators would concentrate their efforts with respect to holding companies on assuring that subsidiary banks are kept sound, both by requiring adequate capitalization and by limiting transactions of the banks with holding company affiliates. Great pains would be taken to publicize corporate separateness, and it would be left entirely to private investors in holding company obligations to protect their own interests.

A major advantage of this approach would be the flexibility allowed bank holding companies in planning their own development. At the same time, bank holding companies would be less likely to have an unfair advantage in competing for funds, since private creditors would hopefully be aware that debts of nonbank affiliates were not backed by the bank or protected by the regulators.

On paper, this approach has great appeal, but it, too, has several problems. The most important, it seems to me, is that private creditors and the public at large have some distance to go before they fully understand the implications of the difference between banks and bank holding companies. No mere announcement of this difference would produce, overnight, a private market capable of dealing with this complex, evolving phenomenon. Although time would be necessary for such an approach to evolve and mature, I think the regulators would have to make the best use of this time to make the public more aware of the differences.

Because of the very real potential for major problems, then, I reject both of the "extreme" regulatory approaches. I am opposed to extension of regulatory power where no clear public need is shown, and thus reject bank-like regulation as unduly expensive and as contrary to the public interest because of the way it would restrict the activities of bank holding company management. At the other extreme, I do not believe that private market forces are fully capable at this stage of effectively policing the affairs of bank holding companies.

Therefore, I am of the view that thought should be centered on developing a regulatory approach that fits the current situation, and is capable of being adapted to conditions that may exist in the future.

If this approach is taken the adequacy of present laws governing transactions between banks and the holding company or its affiliates would need to be reexamined and careful thought would need to be given to the question of how such transactions would be monitored by the regulatory authorities. At the same time, private investors, bank depositors, and the public in general would need to be convinced of the differences between banks and holding companies. Perhaps this might be accomplished through changes in public reporting by bank holding companies and special requirements that would prohibit the sale of bank holding company debt obligations in any way that might tend to make them seem like obligations of banks.

Finally, when it appears that there is significant potential for damage to the banking system or to the public interest, the Federal Reserve should clearly have the power to act. Yet under present law there is no administrative remedy for the Board to preclude or prevent unsound practices or violations of law by nonbanking subsidiaries of bank holding companies. Recent events have underscored the need, alluded to by the Board in its two most recent annual reports, for legislation to authorize the Board to institute cease and desist proceedings to prevent unsafe or unsound practices or

violations of law by bank holding companies. We expect to submit draft legislation to the Congress for this purpose in the near future.

Clearly there is no easy answer to the problem. Any progressive steps will be difficult for the regulators to implement and will create concerns of over-regulation in the minds of some bank holding company managements. The banking system could take a short-run viewpoint by ignoring these problems or resisting regulatory efforts to cope with them. Preferably, I hope it will take a long-run viewpoint and provide constructive assistance in the development of a regulatory approach that will allow for orderly, progressive growth of the bank holding company industry.