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PUBLIC INTEREST FACTORS AND THE BANK HOLDING COMPANY ACT

Remarks of

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Board of Governors

Federal Reserve System

to the

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Public Interest Factors and the
Bank Holding Company Act

If the practice of declaring the beginning or the end of new eras had not been proved, in our fluid times, both risky and futile, I would say that when at the end of 1970 the Congress enacted and the President signed into law a complete overhaul of the Bank Holding Company Act, banking entered into a new era.

While I would not venture so far, I can say with confidence that things haven't been the same since in the financial world, and they do not seem likely to settle back soon. As a simple statistical illustration it can be noted that before the 1970 amendments to the Bank Holding Company Act became law there were 121 registered bank holding companies, with approximately 16 per cent of the deposits of the U.S. commercial banking system. That did not include the one-bank holding companies brought under regulation by the 1970 amendments. Just three years later, there were 1,677 registered bank holding companies -- including the one-bank companies -- and they held some 65 per cent of total commercial bank deposits.

You have no idea how exciting that statistical exercise is unless you have sat up nights reading the many hundreds of applications the Federal Reserve Board must pass upon yearly under the revised bank holding company law. The Board will probably handle close to 1,000 individual cases this year. Still, I have not come here today to boggle or benumb the mind with numbers, however they may make you weep for your overworked bank regulators.

What I do want to talk about, against the background of that rather changed condition in our financial structure, is a regulatory metamorphosis that had been going on before the 1970 amendments, and that has now become one of the main features of bank regulation.

Historically, United States bank supervision and regulation has been, from its inception in the Bank Safety Fund Act of the New York legislature in 1829, and the National Banking Act of 1863, focused on protection of bank deposits through prevention of unsafe and unsound banking practices. That is, bank law, bank regulation, and the supervision that implemented regulation all had an essentially negative cast: the whole idea was to avoid financial catastrophe by putting the regulatory hand into commercial banking practices, and forbidding certain procedures regarded as too risky.

The result was an American banking system that is on the whole very safe and sound, but also a banking system that, until the Bank Holding Company Act was revised by the Congress in 1970, was becoming a somewhat ossified regulatory ward of government. Banking occupied an economic enclave where it enjoyed special protection from competition -- and was certainly as regulated as any other industry.

Let me be clearly understood. I am not saying that safe and sound banking is or should be any the less important to bankers than it has been in the past. I am not saying that regulators and supervisors, including the Federal Reserve, should ever for one moment lose sight of the fact that the most basic of all their purposes is the protection of the public's deposits. Unless we can leave our money with our banker with confidence, we in fact have no financial system, for money in the mattress gives its owner little besides a backache, and gives the nation only an aching investment void.

The mother-hen regulatory attitude toward banking was strengthened by the banking disasters of the 1920s and the 1930s. There was a nearly uncritical acceptance of the idea that the failure of half of the nation's 30,000 banks between 1920 and 1933 resulted from bad bank management, together with an admixture of financial abuses by some bank managers. Much of the blame -- ignoring the effects upon banks of the long agricultural depression of the 1920s and the worldwide economic collapse that began in 1929 -- was placed on two banking factors: over-chartering of banks that led to excessive competition for deposits and profits, and banks searching for profits in the alien regions of the stock market. Bank failure and how to prevent it became more than ever the fixation of bank regulation and supervision.

Consequently, the Banking Acts of 1933 and 1935 took up the old tradition of prohibitions and restrictions of bank activity in the name of safety, and carried them further. They introduced a prohibition on bank investment in corporate stocks, severe restrictions on bank underwriting of securities, limitations on acquisitions of investment obligations, on aggregate indebtedness, and on operations through and relations with subsidiaries, while, as a cushion against losses, there were increased reserve requirements. A "need" test was introduced to limit chartering of banks and branches. The payment of interest on demand deposits was prohibited, and the Federal Reserve Board was directed to place limits upon rates payable on time and savings deposits.

As well as introducing greater safety, these rules, of course, had a tranquillizing effect upon profit expectations in banking. Restraints on competition, imposition of prohibitions or restrictions inhibiting deposit growth, and limitations on structural change all leaned in the direction of increasing income for surviving banks, while activity restrictions and specification of a higher level of capital maintenance tended to hold income down. Banking, to put it with the utmost gentility, tended to settle into a rut, with little impetus for change by either the regulated or the regulators.

There had been earlier stirrings, and the Truth-in-Lending Act of 1968 and the nondiscriminatory lending provisions of the Civil Rights Act of 1968 added new responsibilities to banking, but the 1970 amendments to the Bank Holding Company Act finally brought to an end the somnolence of banking and bank regulation behind the safety and soundness shield. These changes made, and continue to make, banking and the regulation of banking a very different business, its viewpoint shifted and its objectives changed.

As I have noted, safety and soundness in banking was, is, and will remain the sine qua non of our financial system. But these recent changes in bank law have given recognition, and steadily increasing scope, to the idea that such a sine qua non is not an end in itself, but provides a strong foundation on which a structure of many useful banking innovations can be built.

> Let me emphasize, then, that such legislation has transfigured bank regulation, adding to its prohibitory responsibilities for safety and soundness in banking, multiple responsibilities of a positive character for seeing to it that the nation's banking system is much more than a safe repository, that it is a competitive, aggressive economic force in the economy, accepting the public interest as the master criterion for the use by banking of its new freedom to expand and innovate.

The Federal Reserve Board expressed its view of the new balance needed for a more virile banking system that is at the same time oriented to the public interest in a Statement of Principles sent to the Congress in 1969. Congress was then considering how to permit banking organizations, through the Bank Holding Company Act, to broaden their scope of services.

The quid for this quo, as suggested by the Board and authorized by the Congress, was that the basic regulatory consideration, in deciding whether to permit any particular bank holding company proposal to go through, should be a positive benefit to the public.

My point in reciting this to you is to stress that the Board is using its regulatory responsibility under the Bank Holding Company Act to obtain desirable objectives in addition to bank safety and soundness. These objectives include, fundamentally, a growing degree of responsiveness by commercial banking to the objective of giving the public better -- not merely expanded -- banking and bank-related services, in an atmosphere of sharpened competition better serving the public convenience and needs.

> My purpose in stressing the altered bank regulatory outlook at the Federal Reserve is that I want you -- bank counsellors -- to take home to the banks and the bank holding companies you advise a simple, but important message: it is not enough for applications under the Bank Holding Company Act to show that no harm will be done -- they must show that some good will be done.

And I have a further message: a *pro forma* showing of public benefit will not do. As I will be demonstrating, the Federal Reserve Board has been moving and, I believe, will continue to move, in the direction of greater specificity with respect to public benefits in its decisions for or against bank holding company proposals. And the Board has made it plain that it is not up to the Board or its staff to winnow out elements of public benefit when it is asked to approve bank mergers or holding company acquisitions of existing or *de novo* businesses -- the burden of showing such benefits lies full weight upon the applicant.

Administrative Aspects

With the foregoing history and adjurations in mind, let me tell you a little, first, of how the Board -- and the Federal Reserve System -- operate with respect to our bank holding company regulatory responsibilities, and, second, try to draw from Board decisions a sample of citations demonstrating the Board's emphasis upon a positive showing that the public will be better off if the Board approves the application before it.

If some of the following description of how the System receives and handles holding company and merger applications seems excessively basic, I ask your forebearance. I am going to the fundamentals because we receive so many faulty applications, and an application that is not made correctly and completely is an application that suffers delay. As you probably know, we try to act upon applications within 90 days of the time they are received. But that 90 days does not begin to run until the application is completed and the entire record of the case is presented to the Board. Most cases of long delays in acting on applications result from failures to submit necessary information.

The administrative process begins when applications to form or expand bank activities of a bank holding company are submitted to a Federal Reserve Bank on forms F.R. Y-1 and Y-2, respectively, with supporting material attached. Similarly, applications to engage in nonbank closely related activities are filed on Y-4 forms. Prior to filing and during the Reserve Bank's analysis and processing of an application, the Reserve Bank is prepared to assist applicants in order to insure the application will pass the tests of legal sufficiency and informational adequacy. In some cases the Reserve Bank has been delegated authority to take final action. Otherwise, the application, along with the Reserve Bank staff analysis, is forwarded to the Board for decision. At the Board, a review and further staff work takes place before the application is placed on the Board's agenda.

By all means be certain to discuss any unusual aspects of your proposal with the appropriate Reserve Bank. This assistance, let me stress, is technical only, and in no way affects the final decision on the case: it can only help expedite that decision -- whether it be yea or nay. But the assistance available to you at the Reserve Banks can save you, and us, a great deal of expense and time.

During the time that preparation of an application is underway, be sure to complete any prerequisite actions in a timely fashion. Such prerequisite actions might include meeting publication requirements, filing with other agencies, and preparing other or companion applications which will have to be filed with the Board. An example of a companion application is a Section 4(c)(8) application accompanying a Section 3(a)(1) application when the bank holding company to be formed will operate, either directly or indirectly, a permissible activity such as an insurance agency.

We are not rigid in the use of our application forms. The world is too wide and varied for that. Modifications of application forms have been permitted to suit the particular circumstances of certain proposals. Moreover, efforts have been made to simplify applications as much as possible. For example, applications involving stock rights offerings and bank shares acquired in a fiduciary capacity with sole power to vote may be submitted in letter form. Deviations from the forms cannot, of course, be very numerous, and must relate to truly unique situations. Therefore, if you believe you have such a situation, it is best, once again, to get the advice -- at an early time in the application cycle -- of your Federal Reserve Bank.

It is not helpful to you or to us for surprises to appear late in the process of application. One such surprise may be plans that have to do with matters such as divestiture, capital improvement programs, or borrowing expectations. To the extent possible and consistent with the corporate interest, you should include information about these plans in the application.

In this connection it should be noted that confidential treatment is accorded, by Board determination, to certain facts in applications, including information about business results that would be beneficial to a competitor. We hold as confidential, for example, information about pricing, sales breakdowns and detailed profits results.

All the above discussion is applicable to both Section 3 and Section 4 applications. I now want to offer some special suggestions about applications under Section 4 -- nonbanking activities.

The activity to be engaged in should be defined completely and precisely so that: one, the public in the communities concerned will know exactly what the proposition is, and two, publication in the Federal Register will be correct. In publication notices, think carefully before using non-specific language like "and other activities incidental thereto."

We require that when an applicant publishes notice that it may engage in a certain activity there should be a reasonably definite plan for commencing that activity and that at the time of notification, this plan be made known to the Federal Reserve.

Let us now assume that you have filed an application with a Federal Reserve Bank complete in all respects, giving the facts succinctly and straightforwardly, making the best positive case, in specific terms, for public benefit, and that it does not fall within the guidelines of cases that can be decided on delegated authority by a Reserve Bank. The application is sent to the Board, where the Board's staff considers it from stem to stern. Full weight is given to the opinion and recommendation of the Reserve Bank. If the Board's staff does not concur with Reserve Bank opinion, staff from the Reserve Bank is invited to argue the Reserve Bank's viewpoint before the Board.

The Board's staff may not be unanimous. Even if it is, the Board will in most cases hear presentation of the case from various viewpoints: legal, banking markets and supervision and regulation. The Board Members will have had the case in hand for some days, with information that it is to be on the agenda on a certain date, or within a short time. The procedure at the time of Board consideration gives Members an opportunity to have a colloquy with staff aimed at answering questions in the minds of individual Members, or at doing a little polite battering of staff to make sure the staff members handling the case, and their superiors, are fully informed and have thought the matter through thoroughly. This Board discussion very often uncovers questions requiring the case to be sent back to staff for more work -- and perhaps inquiry with the applicant -- before the Board can reach a decision.

Many cases come before the Board on its "Consent Calendar." These are cases which present no difficulties apparent to the staff, raise no new issues in the opinion of the staff, and fall within general guidelines developed by previous decisions in like cases. However, unlike a court, the Board is not always able to act on the basis of stare decisis. For the most part, our regulatory decisions involve so much market, economic and other non-legal matter that it is not wise to rely on past decisions as a dependable indicator for future rulings. This does not mean, however, that the Board does not continuously strive for consistency in its decision-making process.

The Public
Interest

There are certain considerations in nonbank holding company cases that are fundamental, for example, whether a nonbanking business can qualify as being so closely related to banking or the management of banks as to be a proper incident thereto. Applications that conflict with such considerations cannot be approved: even if the Board should feel -- for instance -- that it would greatly benefit the public for a certain bank to own and operate a steel mill, that would be contrary to the Act and could not be approved.

Beyond such considerations, however, lie a number of other factors the Board is required by the Act to weigh, and among which it must strike a balance. These include effects upon competition, whether an undue concentration of resources may result, the convenience and needs of the banking public, effects upon the soundness of particular banks or banking in general, whether general economic efficiency is improved, and whether there is a danger of tie-ins or conflicts of interest.

In considering bank acquisitions the Board must consider whether the proposal, if approved, would be contrary to "sound banking and public interest." In the case of nonbank applications the Board must assess whether the proposed activity 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 interests or unsound banking practices."

From this it seems obvious to me that if one were asked to state the central criterion of the Bank Holding Company Act for the expansion of bank holding companies, one would have to say that -- beyond the fundamental technical provisos -- it is the criterion of "benefits to the public." The public interest, as cited above, is an accordion consideration englobing nearly all else.

This does not rule out the case where the only discernible alteration of the economic balance would be the creation, or strengthening, of a profitable business. That is a very basic public benefit, involving new taxable resources, employment prospects, ancillary businesses, in short, "gains in efficiency." But this public benefit can be said to be present in most instances and is not generally sufficient by itself to outweigh adverse effects that might otherwise be present.

My point is that if -- as in a great many cases -- there are adverse factors to overcome, there is a strong likelihood that an application, to be successful, will have to show other and quite specific ways in which the public will be benefited.

What has the Board made out of this, in case terms?

With the hope that it may be helpful to you in deciding what applications to bring before the Federal Reserve, and what tests they must meet in terms of public benefit, let me cite a few Board decisions:

Section 3 Applications

Adverse effects on either existing or potential competition may be outweighed by convenience and needs considerations. Such was the Board's November 1973 decision on the application of First National State Bancorporation in New Jersey to acquire Mechanics National Bank. In the approval Order the Board, noting the holding company's commitment to inject $2 million in capital and new or improved services proposed, stated:

> "Although it appears that similar services are presently available in Bank's area, the increased and improved services would provide customers in both markets with an additional convenient source of full-service banking. Moreover, Bank is the principal bank serving the area encompassing the Fort Dix Army and McGuire Air Force Bases. Bank's activities and services are very limited at these locations and Applicant plans to appreciably increase those services."

Convenience and needs considerations, however, are often not overriding. An example is the denial last December of the application of the Dallas bank holding company, First International Bancshares to acquire Citizens First National Bank of Tyler, Texas. This case might have been approved, except for a pattern indicating that First International had entered or was planning to enter a number of secondary SMSA markets in Texas by acquiring a major bank in each market. The Board's Order noted that the Board did not need to await, but could anticipate, undue concentration among holding companies, in order to halt such concentration before it gained momentum. Thus, although there were factors of public convenience, the Board contended that approval of the application would have significant adverse effects upon potential competition in the Tyler market and in the State.

One should note in this Order the dissenting statement arguing strongly that approval would have "significantly improved" the convenience and needs of the Tyler area and the State of Texas by the affiliation of such local institutions in the holding company network.

In a number of recent cases, the Board has set forth a critical standard for the structure of bank holding companies: it must not be such as to threaten to drain strength from banks. That is, we are still very much in our traditional business of guarding bank safety and soundness. For example, the Board's January Order this year denying the application of Mid America Bancorporation, in Minnesota, to acquire the First National Bank of Lakeville said, in part:

> ". . . a holding company should be a source of financial strength for the banks in its system . . . . In reviewing such factors in this case, it is the judgment of the Board that the financing plan proposed by Applicant does not provide Applicant with the necessary financial flexibility to meet the financial needs of its present subsidiary banks or Bank."

In the approval last December of the application of Lloyds Bank, Ltd. of London to acquire First Western Bank and Trust Company, of Los Angeles, added competitive strength was an important element:

> ". . . it appears that consummation of the proposal may increase competition, as affiliation with Lloyds Bank should make Bank a stronger and more vigorous competitor of other California banks in local banking markets throughout the State."

And better service to the public was also decisive:

> "There is no evidence in the record to indicate that the banking needs of the areas served by Bank are not being met. However, the proposed acquisition, by increasing the financial and managerial resources available to Bank, would enable Bank to offer a wider range of services, particularly in international and wholesale banking. In retail banking, Bank would once more be able to open new branches, thus increasing services and competition in local banking markets throughout the State."

The Board has discussed other public interest factors under Section 3. It has expressed concern about the funds of an employee profit sharing trust being invested in a directly competing bank, about the practice of withdrawing recently acquired banks from Federal Reserve System membership and the monetary policy implications of such an action. And the Board has been cautious about applications where certain covenants not to compete are part of the proposal.

Section 4 Applications

Once an activity has been determined to be closely related to banking an applicant must show that his proposal will produce net public benefits, with the burden of proof upon the applicant.

This was made plain when the Board last August denied the application of Tennessee National Bancshares of Tennessee to acquire an industrial loan and thrift company in the same market as its lead bank. Approval would have increased applicant's share of consumer loans from about 12 per cent to 19 per cent. The denial stated:

"Applicant has the burden of demonstrating that the proposed acquisition will be in the public interest. In seeking to meet this burden, Applicant indicates that affiliation would increase the financial resources available to Company. Also, Applicant anticipates establishing additional offices for Company. However, upon consideration of the aforementioned anticompetitive factors, the Board finds that the public benefits to be derived from this affiliation do not outweigh the adverse competitive effects of the proposal."

In Section 4 cases also the Board has been very blunt about protecting bank soundness. In denying, last June, Chemical New York Corporation's application to acquire CNA Nuclear Leasing, Inc., of Boston, the Board made it clear that this traditional concern with the general interest has by no means been lost in the welter of the Board's bank holding company concerns:

". . . one of the primary purposes of a holding company is to serve as a source of financial strength for its subsidiary banks. In the Board's judgment a proposal such as the present to acquire an extremely leveraged company with very heavy requirements for funds could seriously impair that ability."

And lack of an adequate showing of public benefits also counted heavily:

". . . The Board recognized the public benefits that attach to the availability of suitable financing for nuclear fuel cores. However . . . there are no reasonably expected public benefits in this particular case such as greater convenience, increased competition, or gains in efficiency that outweigh the aforementioned possible adverse effects."

It is not enough for public benefits of some degree to be present and enumerated. They must also be substantial enough to offset any adverse factors, and they must arise from the bank holding company connection. In its decision last August denying the application of Bankers Trust Corporation, of New York, to acquire Public Loan Company of Binghamton, N.Y., the Board stated:

> "The public benefits fall short . . . Public Loan appears to be of adequate size and financial soundness to obtain necessary financing at competitive rates . . . With respect to the management of Public Loan, there is no evidence of record to demonstrate that family management has in any way lessened the ability of the company to grow and prosper."

In the case of the application by Chase Manhattan Corporation of New York to acquire Dial Financial Corporation, Des Moines, decided in January, public benefits claimed were found insufficient to override adverse factors. Although the applicant proposed a program to open new offices and expand financial services offered, as well as a modest program that would have reduced rates on some consumer loans, the Board concluded that:

> "While the proposed acquisition would clearly lead to some public benefits, there is little indication that the . . . claimed benefits are not likely to be obtained in the absence of the acquisition."

Chase has submitted a new application in this case which has not yet come before the Board.

A prospective increase in competition was influential as a public benefit in the Board's recent decision to permit bank holding companies to engage in certain kinds of courier services. The Board noted that only a limited number of firms were in the business and found that holding company entry would therefore be pro-competitive. The Board concluded:

> ". . . that the balance of public interest factors it is required to weigh is likely to be favorable in a sufficient number of instances to justify adding certain courier services to the list of activities the Board has determined to be closely related to banking."

The Board has made very specific public benefits its criteria in weighing the advantages and disadvantages of applications in certain fields, most notably, underwriting of credit life and credit accident and health insurance. There, the public benefit of lower premium rates, or better policy benefits, including wider coverage, are deciding factors. In other nonbank acquisition areas, for example consumer finance companies, lower finance charges may be considered by the Board to be an appreciable public benefit.

Conclusion

I find the trend I have been outlining a very welcome one. The decisions I have cited, and a number of others, I think, show not only that the Board requires measurable indications of gains for the public from bank holding company acquisitions, but also that the Board has moved significantly in the direction of making those gains quite specific. In whatever form public benefits may be realized -- and they can probably be summed up in efforts of numerous kinds to insure sharper competition among banking organizations --

it appears to me to be the intention of the Board to assure itself that those benefits will be demonstrable and real.

This is a trend that I find responsive to the needs of the public, at a time when economic efficiency calls, in many instances, for larger aggregates of economic power. I believe that it is right and proper for the public to insist that where economic units grow larger, the public regulatory power should be used to insure that those units are responsive to the convenience, the needs and desires of individuals, small businesses and of society as a whole. I believe this is also good for banking, because the long-term effect will be to strengthen the banking system by strengthening the esteem of the public for banking. I find insistence upon the public interest in the administration of the bank holding company law both good government and good business. As one of the regulators administering that law, I expect to support and encourage continuation of the trend toward putting public benefits front and center among the criteria for approving bank holding company acquisitions. I think that you, as bank counsellors, and the banking organizations you advise, will find demonstrable long-term profit in doing the same.

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