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TWO KEY FACTORS IN THE REGULATION OF BANK HOLDING COMPANIES

Remarks of

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to

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TWO KEY FACTORS IN THE REGULATION OF BANK HOLDING COMPANIES

Since that New Year's Eve in 1970 when the highly restrictive Bank Holding Company Act of 1956 was liberalized by the President signing the Bank Holding Company Act Amendments of 1970, the Federal Reserve Board has had the task of presiding over the transformation, in form and function, of the American banking system.

A Member of the Federal Reserve Board can take the view that this has been a great and exciting challenge, or that it has been a new workload of almost crushing size. But he cannot be indifferent to it, because each Member of the Board must plow his way through scores or even hundreds of pages of documentation concerning each of hundreds of bank holding company cases per year, to the point where he feels he is well enough informed to come in his own mind to a yea or nay conclusion. He must then participate in what is often a lively--sometimes even heated--discussion at the Board table, and cast a publicly recorded vote on the matter.

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Whatever his feelings about this task, each Member of the Federal Reserve Board must recognize that the Board itself was instrumental in bringing it about, and that the amended law they are implementing is very much a product of the Board's own feeling in 1969, that

> "...consistent with continued growth and development of a dynamic and increasingly complex economy, banks should be granted greater freedom to innovate new services and procedures...subject to administrative (supervision) to prevent activities inconsistent with the purpose of the Act."

This was the liberalizing heart of a Board Statement of Principles with respect to bank holding companies sent to the Congress on February 20, 1969. It was a declaration that, in principle, banks should be given a much wider range of activities in the U.S. economy than had been open to them since the bank reform laws of the 1930s. But the statement was hedged with other objectives the Board believed a revised bank holding company act should embrace. Included among these was a statement that:

> --In considering whether to permit a bank holding company to engage in a nonbanking activity, the balance of benefits and potential dangers should be a deciding factor. Benefits would include the public convenience, increased competition and gains in efficiency. Potential dangers would include undue concentration of resources, decreased competition, conflicts of interest and threats to the soundness of the nation's banking system.

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These are some of the guiding principles of the new bank holding company law that emerged from the ensuing year of Congressional debate. And they are very much principles considered in the Board's debates in deciding bank holding company cases. As you will note, competition is prominent on both sides of the benefits-dangers equation.

The mushroom-like growth of bank holding companies in Colorado and many other parts of the Nation has provided the Federal Reserve the opportunity to promote competition, but it also has produced new supervisory challenges as bank holding companies grew in size, scope and complexity. Reflection on bank holding company movement data shows the magnitude of this task and the opportunity given the Federal Reserve. For example, in Colorado from 1967 to year-end 1974 bank holding companies grew in number from 3 to 69 and in per cent of the state's commercial bank deposits from 22.8 to 79.3. Nationally by year-end 1973 about 68.1 per cent of commercial bank deposits was held by bank subsidiaries of 1,616 bank holding companies. During the same period the supervisory tasks became more complex as bank holding companies expanded their operations into other activities closely related to banking. As this trend developed, both banks and bank holding companies evidenced a definite trend towards higher leverage and more potentially volatile liability structures.

Today, I want to share with you several aspects of Federal Reserve policy towards the goals of fostering competition and supervising and regulating bank holding companies as the diversified financial institutions they have become.

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Competition in Banking

Competition has been a key factor in all the bank holding company legislation created by Congress over the past 20 years. In the original Bank Holding Company Act of 1956 and in the 1966 and 1970 Amendments to the Act, it is clear that Congress proposed to permit Bank Holding Company expansion only if such expansion could be achieved without significant anti-competitive effects in commercial banking and other financial markets. As the regulatory agency responsible for administering the Act, the Federal Reserve Board devotes substantial effort to evaluating the competitive implications of every acquisition proposal, as well as doing research on the competitive aspects of the bank holding company movement.

Economists believe that the number of firms in a market and the size distribution of those firms are the primary structural determinants of the level of competition in a market. The most common shorthand measure used to describe market structures is the concentration ratio, which is simply the share of the market held by, say, the 3 or 4 largest firms in the market. So, in Board decisions on Bank Holding Company applications to acquire banks, you will usually see, as part of the competitive analysis, references to the share of market deposits held by the banking organizations involved.

Such ratios are, of course, relatively easy to compute; and because they are numbers, they give the impression of great precision. Yet, there are obviously factors not measured by concentration ratios that influence the degree of competition in a market. One is the

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management factor. I am sure you are all aware of certain banking organizations in this area and around the country that have reputations as aggressive competitors. When these organizations are in a market, competition is usually intense, irrespective of concentration ratios. Nonetheless, concentration ratios are important and recent research by the Federal Reserve Board's staff shows a relationship between concentration in banking markets and the performance of banks in those markets as measured by the prices and availability of banking services.

While there are more than 14,000 banks in this country, local banking markets frequently are highly concentrated. The structure of local markets is important because the local banks are the only practical sources of banking services for most individuals and small businesses. Even in metropolitan areas, where there are usually a fairly large number of banks, concentration is high. For example, in Denver the 3 largest banking organizations have 51.9 per cent of market deposits; in Colorado Springs this concentration ratio is 53.5; and in Pueblo it is 68.1. In many rural areas concentration is even greater. Many of these markets have only 2 or 3 banks; and quite a few have only one. Concentration ratios suggest, therefore, that many local banking markets are not structurally protected against possible anti-competitive temptations on the part of one or more bank managements. Public policy, therefore, should weigh carefully any potential adverse effects on competition in the evolution of the banking structure.

A discussion of concentration as a measure of competition would not be complete without saying a few words about statewide

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concentration. Frequently, statewide concentration has become an issue in states where bank holding companies have been active in recent years. My own view is that the emphasis on statewide concentration has been overdone. Generally, some increase in the statewide concentration of banking resources occurs if bank holding companies expand through acquisitions of banks, but the crucial consideration is concentration at the local market level. If bank holding companies expand through acquisitions in markets in which they are not already significantly represented, local market concentration may change little even though statewide concentration may increase somewhat. Indeed, if expansion is through "foothold" or *de novo* acquisitions, concentration in local markets may subsequently decline tending to increase competition. Therefore, although I do not think statewide concentration should be ignored, in general, if combinations among the larger banks or bank holding companies in a state are denied, statewide concentration should pose no serious competitive problems.

It seems clear that under some circumstances bank holding company expansion can be procompetitive. Entry into a market via the establishment of a new bank adds to the number of competitors. But in my view entry through acquisition can also increase competition. There are many banks today, especially the smaller ones, that have management succession problems, inadequate lending limits, and insufficient resources to expand their financial services or to take advantage of the technological and managerial improvements rapidly

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becoming available in the banking industry. Of course, there are ways to deal with these problems other than affiliation with a bank holding company. Assistance from correspondent banks and entry of new banking entrepreneurs are examples, but bank holding companies offer one solution to such problems and have shown the ability to effectively accomplish such objectives. Many bank holding companies have the financial resources and managerial talent to correct bank problems and enable them to become strong competitors offering a broad range of banking services.

Legal limitations on bank holding company growth abound. Federal law has left the determination of interstate expansion of full-service commercial banking facilities to the states by prohibiting such expansion unless expressly permitted by the states. Constraints on intrastate expansion are imposed by the application of competitive and financial standards by the Federal Reserve Board under the Bank Holding Company Act and the application of anti-trust laws by the Department of Justice.

Fourteen states prohibit multibank holding companies. Such restrictions are, in my judgment, clearly anticompetitive since raising barriers to entry into local banking markets in the state, increases the ability of the banking organizations in those markets to exploit whatever monopoly power they have. Prices charged by these banks may not be greatly different than those charged in other states, but understandably a bank might try a little less hard to serve its customers well if it perceives no threat from any outsider.

Recently, some states have instituted and some are proposing a new type of restriction on bank holding company growth, namely limiting

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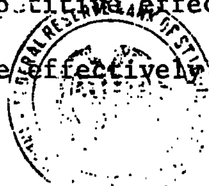
the share of state deposits that a bank holding company's banks can have. Such restrictions appear to be based primarily on concerns about statewide concentration. Now I do not mean to suggest that there is no legitimate basis for this concern, but I believe it is a clumsy instrument for dealing with perceived competitive problems. Recall from our earlier discussion that competition in a local market should be the primary focus for both state and federal regulators. Setting limits on the percentage of state deposits may mean that some bank holding companies may not even be able to expand de novo. Such restrictions are clearly anticompetitive because they reduce the likelihood of new entry into local banking markets. But more importantly they may lead to a general reduction in the competitive vigor of the larger organizations in the state, an event that could have harmful effects in markets throughout the state.

A state desiring to impose size limits on bank holding companies should do so with qualifications designed to promote competition. For example, I would strongly urge the exemption of de novo expansion for bank holding companies that are over the limit on deposit or asset size. Another desirable exemption would be for acquisitions of banks under a certain size, say $10 million, if the bank holding company has no subsidiary banks in the market in which the bank is located. Such an exemption seems justified because these "foothold" acquisitions are tantamount to de novo entry. These kinds of exemptions would preserve the beneficial procompetitive effects of bank holding company growth while at the same time effectively placing a lid on the level of statewide concentration.



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Competition is an area where both research and experience are valuable tools for analyzing possible policy alternatives. The thoughts I have just expressed are based on personal experience as well as research by the staff of the Federal Reserve Board.

Experience and research are also necessary in formulating supervisory policies, however, an additional step must also be taken--an apparatus must be set up. Therefore, I would like to continue my discussion of the bank holding company area by focusing for a few minutes on the establishment by the Federal Reserve of a system for monitoring the activities of bank holding companies and the development of procedures to implement our supervisory responsibilities.

Bank Holding Company Supervision.

In 1970, the one-bank holding companies were brought under Federal Reserve regulatory authority. Remarkably, the Congressional debates were almost devoid of discussions about how the diverse activities of bank holding companies should be regulated as on-going businesses. As the bank holding companies expanded rapidly into permissible nonbanking activities through acquisitions financed mainly by increased leverage, the Federal Reserve Board became increasingly concerned about fulfilling the regulatory responsibilities assigned by Congress. With the equity base of both banks and bank holding companies shrinking relative to overall size, while concurrently greater reliance was being placed on "liability management," uneasiness regarding the capital adequacy and liquidity of these organizations became more pronounced. Thus, the Board began to ask questions such as:

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What degree and form of regulation and supervision should the Federal Reserve System adopt for bank holding companies?

Does the public understand the legal and regulatory distinctions between the bank holding company and its commercial bank subsidiary?

What are the problems involved when a commercial bank subsidiary of a bank holding company is regulated more strictly than its nonbank affiliates?

Can problems in a bank holding company's nonbank affiliates harm its commercial bank subsidiary?

What authority does the Federal Reserve have or should the Federal Reserve have to prevent a bank holding company from engaging in unsound or illegal practices?

During 1973, a task force at the Board was formed to study these and other related questions. Beginning in August of 1973 the Board staff began discussions with three outside consultant groups which included bank holding company executives, investment bankers, accountants, rating agency representatives, financial analysts, lawyers, executives of nonbank financial institutions, and academic experts.

These groups discussed three possible approaches. The first approach was to regulate and supervise bank holding companies much the way commercial banks are supervised; the second approach was to emphasize the distinction between the bank and its nonbank affiliates. Under this approach there would be little regulation of the nonbank affiliates. An effort would be made to insulate the bank from its nonbank affiliates and to clarify in the minds of the public the distinction between the bank and its nonbank affiliates and the restrictions imposed on transactions between these two entities. The final approach was a combination

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of the first two approaches where the nonbank affiliates would be regulated to some degree short of bank-type regulation and the bank would be insulated as much as practical.

In early 1974, Beverly Hills Bancorp. was not able to meet its maturing commercial paper issues. As a result this bank holding company's only bank was sold to a large California organization. We learned three things from this case: (1) the public confused the bank holding company and the bank; (2) because of this confusion the bank could not be completely insulated from troubles in the bank holding company--in this case the bank suffered a deposit loss of over $20 million (more than 15 per cent) as a result of the parent's troubles, and (3) we did not have sufficient current information on the nonbanking activities to make it possible to predict or prevent the problems that occurred.

As 1974 unfolded, bank holding companies and banks were exposed to increasing financial pressures. Some bank holding companies found the quality of their assets deteriorating and themselves faced with liquidity problems. The Board established an ad hoc task force to quickly determine those bank holding companies with potential or actual financial problems. As a result of this experience and of previous discussions with our staff and the outside consultant groups, the Board, during the last quarter of 1974, established the Program for Bank Holding Company Analysis to monitor the bank holding company industry on an on-going basis.

The primary objectives of the program are (1) to gather sufficient information on the nonbank portion of a bank holding company in order to detect actual or potential financial difficulties that could

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cause a problem for the affiliated bank or impair the parent's ability to raise funds to be invested in or advanced to its commercial bank subsidiaries; (2) to monitor transactions between holding company banks and their nonbank affiliates; (3) to analyze individual bank holding companies and industry trends; and (4) to recommend when intervention into the affairs of a particular bank holding company should occur.

The staff group responsible for this program has developed some new reports which are being required of bank holding companies and is currently studying the possibility of additional reports. A supplement to the 1974 Annual Report of Bank Holding Companies was required of bank holding companies with consolidated assets in excess of $500 million and banking assets in excess of $100 million. The principal objectives in requesting this additional information are (1) to obtain data that reflects the distinction between holding company banks and their nonbank affiliates and (2) to provide information to be used in analyzing the liquidity and the portfolio risk, of the nonbank businesses in which a bank holding company is engaging.

Included in this supplemental information are consolidated ex-bank statements. These statements present the nonbank affiliates as a consolidated entity so that these assets and liabilities can be analyzed separately from those of the banking affiliates. Other information requested includes a maturity schedule of some assets and liabilities, information on the quality of assets, loan commitments, stand-by letters of credit, and lines of credit. This is information which had not previously been available to us.

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A new report on intercompany transactions and balances is currently being required of bank holding companies with banking assets in excess of $250 million. This report is designed to monitor transactions between holding company banks and their nonbank affiliates in order to detect transactions which might weaken the financial condition of holding company banks. This report is presently being submitted on a monthly basis. Based on our findings from the first few months we will decide either to continue on a monthly basis or to change the reporting period.

Other reporting changes are being contemplated or are under study. A revision of the bank holding company annual report incorporating the 1974 supplemental information is expected along with some form of quarterly report for bank holding companies. Moreover, additional special reports will be required if circumstances warrant.

Although these data needs will result in some additional reporting burden, we believe the information necessary so the Federal Reserve may be adequately informed about the operations of the nonbank activities of bank holding companies and their transactions with their bank affiliates. Furthermore, the need for on-site inspections will be held down.

The second step is analysis based on the reports discussed above, currently available information on holding company banks, such as, examination reports and call reports. The analysis will begin with a computer screening program designed to trace key financial ratios and other indicators, to be followed by a thorough analysis of the larger individual bank holding companies.

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Once a situation that is potentially harmful to banking subsidiaries is detected, some form of action will be decided upon. This action will vary depending upon the circumstances. A first step is usually discussion with management about the problem and any plans they may have to correct it. An on-site inspection of the holding company may precede or follow such discussion with management. If the situation warrants, we could also exercise our cease-and-desist authority to prevent unsound practices from continuing.

It is possible for the condition of a bank holding company to deteriorate to the point where it would be necessary for the holding company's bank to be taken-over by another organization. This could occur as a result of problems in the bank or in a nonbank affiliate. In either case, the Board believes that under existing law circumstances may arise that could make it difficult to arrange such a take-over. We are also concerned with the length of time currently necessary to complete such a take-over.

Because of these concerns, the Board of Governors has recommended to the Congress draft legislation that: (1) would allow the Board to approve an emergency acquisition, consolidation or merger under Section 3 of the Bank Holding Company Act and thus waive the 30-day statutory waiting period prior to acquisition by a bank holding company and (2) would grant the Board authority to approve an acquisition of a bank across state lines when the Board determines that a large bank, or a bank holding company controlling a large bank, is in severe financial difficulty.

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The Federal Reserve is continuously reviewing bank holding company regulation and supervision. One area under study at the present time is the question of capital adequacy and the role of debt in the capital structure. Also being studied are possible restrictions on intercompany transactions between the banking and nonbanking affiliates of a bank holding company. Are present restrictions adequate or should they be changed? There are, in addition, the continuing questions of what activities should be permissible for bank holding companies, and whether a particular bank holding company should be able to acquire a particular bank or nonbank institution.

My intention today has not been to distract your attention too far away from more immediate concerns of improving capital or strengthening asset portfolios or from your equally important role as providers of credit to a recovering economy. Clearly, however, competition in banking and approaches to supervision of bank holding companies are two matters with lower profiles, but in the administration of the Bank Holding Company Act they have a substantial, direct and continuing impact on both regulators and financial institutions. From a regulators viewpoint, I am hopeful that, in this area of overlapping jurisdictions, Federal and State agencies can pursue their goals in a cooperative and enlightened manner. Competition and supervision are necessary environmental features for banking institutions to remain vigorous and efficient producers of the financial services needed to sustain local and national economic prosperity. The Federal Reserve will continue to strive through the Bank Holding Company Act to direct the evolution of a regulatory approach conducive to orderly and progressive growth of the bank holding company and banking industries.

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