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BANK HOLDING COMPANY REGULATION

Remarks of

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Before

the

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As most in this room are undoubtedly aware, with the passage of the amendments to the Bank Holding Company Act in 1970, the Federal Reserve was given the job to administer the regulation of bank holding companies, to approve or deny the acquisition of banks or nonbank companies, and to determine the industries which would be so closely related to banking as to qualify for bank holding company acquisition. After four years of action on such applications, it is now time to take a look at the developments in the bank holding company sphere and assess the changes which this new legislation has brought about in the banking industry structure.

First, it is apparent that the bank holding company idea caught on rather rapidly. From December 31, 1970 through December 31, 1975, the Federal Reserve processed 3,638 applications, of which 3,496 were approved and 142 were denied, or about a 4 per cent rejection rate. In this four-year period, the number of bank holding companies increased from 1,424 to 1,586. One-bank holding companies were about 89 per cent of all companies in 1970, but about 83 per cent in 1974. Meantime, the multibank holding companies increased from 161 at the end of 1970 to 272 at the end of 1974, an increase of nearly 69 per cent. In view of the Federal Reserve's action in these fields, it is of interest to see the change in the control of bank deposits by holding companies in the four-year time span. At the end of 1970, bank holding companies' subsidiary banks held 52 per cent of total U.S. deposits, with 18 per cent controlled by multibank holding companies and 34 per cent by one-bank holding companies. Toward the end of 1974, however, the per cent of total U.S. deposits controlled by bank holding companies had reached 69 per cent with multibank holding companies accounting for 39 per cent and one-bank holding companies for approximately 30 per cent. It is clear that the biggest change in these figures is in the per cent of U.S. deposits held by the multibank holding companies which has risen from 18 to 39 per cent or more than doubling in this four-year period. The per cent of U.S. deposits held by one-bank holding companies has actually declined and the per cent held by all bank holding companies rose approximately 32 per cent.

Our report would not be complete without a quick look at the number of nonbank subsidiaries controlled by bank holding companies. At the start of 1971, there were 3,632 nonbank subsidiaries controlled by bank holding companies. At the end of 1973, this figure had risen to 4,812 and at the end of 1974, approximately 5,000 such companies were controlled by bank holding companies.

Having completed the facts of the current situation, let us turn now to some of the regulatory issues faced in the early days, those being faced today, and what issues are likely to face the regulators in the handling of bank holding company problems for tomorrow.

It should be remembered that the 1970 legislation was an amendment to the 1956 Bank Holding Company Act and that many of the issues which we will mention as important to the Board's consideration in 1970-1973 had been raised as early as 1956 and in the intervening fourteen years.

Among the early issues faced were the structure or degree of concentration to be permitted, the size of bank which could be acquired, and the definition of markets. Certainly, without clear understanding of the markets served by the bank holding companies requesting acquisitions, there could hardly be any focus upon the concentration to be permitted or the competitive limits. Among the most difficult early issues to be faced in nonbank acquisitions were the lack of data and limited experience in interpreting evidence of public benefits, needs, and convenience. Another group of major decisions occurred when determining permissible nonbank activities. As bank holding companies requested approval for entrance into a new field, the Board held hearings and determined whether the requested nonbank activity was closely related to banking.

Finally, a good many of the early issues were also entangled with grandfather and successor right decisions. In these areas the Board had to struggle with the evidence indicating ownership over a long period of time or evidence which seemed to indicate that the company had been acquired just for purposes of multibank holding company expansion in the period since likelihood of the law's passage became clear to the public. Throughout these decisions there was a strong question to be resolved as to the degree to which the Board of Governors should delegate decision-making to its Federal Reserve Banks. As the years wore on, such delegations have increased.

By 1974, the Board of Governors had established a fairly firm pattern for determining competitive implications of a proposed acquisition. Precedents had been set in a number of different areas. But then new problems were becoming evident in the banking system. The Board was faced with questions about capital adequacy, liquidity, servicing of debt, managerial and financial condition, future competition, leveraging, and laundry list expansions. Given the economic and financial developments in 1973 and 1974, it is not surprising that the Board denied a number of acquisition requests in order to conserve the capital and managerial attention of the parent company to problems surfacing in its own family of banks, nonbanks, or within the bank holding company itself.

As bank holding companies and banks often found it difficult to obtain new equity capital in the capital markets during the past two years, the question of debt became of increasing concern to the Board. This raised with the Board of Governors a clear question of debt servicing capacity and in a number of cases the Board denied the acquisition because it concluded that the acquiring holding company was incurring debt which could not reasonably be serviced. Similarly, in a number of recent cases, the creation of a one-bank holding company seemed designed primarily to permit such company to take over the debts of a private individual which he had contracted in order to purchase the stock of the bank. In a few cases, applications were made where the holding company was not only to take over that debt but also debt created by loss in other endeavors. Where no minority stockholders existed, the Board could view such applications as personal restructuring but even for these the Board faced a question of the public interest and benefit by such use of the holding company device.

Certainly an important and difficult matter for the Board has been the question of future competition. In cases where a multibank holding company requested a significant acquisition in an area in which it might either enter on a foothold or a de novo basis, the Board found real problems in approving such acquisition by a major potential competitor. Similarly, where a multibank holding company was already a force within the banking market, the acquisition of banks in the nearby suburban areas raised questions of future competition. Court cases have limited the application of such future competition rulings just as they have rulings by the Board that all stockholders must be given the same offer.

Probably one of the most troublesome problems facing the Board in acting on applications by bank holding companies in 1974 was when an applicant controlled a bank or banks in difficult financial straits. Most of the difficulties were associated with capital adequacy, liquidity, managerial competence, classified assets and internal operating problems. It was not the intention of the Board to publicly penalize such banks by denials of their acquisition requests. The intent was to signal a "go-slow" policy on bank holding company expansion where capital and liquidity positions were less than satisfactory. As a result of this policy, some holding companies withdrew pending applications in view of this attitude of the Board.

Another major problem of the past year has been leveraging. This problem usually occurred when a bank holding company applied to acquire a finance company, leasing operation, or mortgage banking company and then to leverage a small amount of capital heavily. As a result of problems which have surfaced in such companies during the past year, the Board has begun to limit its approval for such acquisitions to a definable leveraging ratio. Foreign acquisitions were also troublesome where the Edge corporation first bought a small amount of stock of the foreign company only to find that it would need to acquire a sizably larger proportion of shares in order to protect its original investment. In a few instances, it has appeared that the holding company's bank subsidiary expanded its credit to minority-owned companies abroad and the bank later on applied for additional stock with the request based on a protection of not only the minority stock owned but the credit extended.

During the four years of processing acquisition requests, the Board has been paying increasing attention to the job of regulation of the holding companies. In essence, its position has been that the holding company should serve as a source of strength to its subsidiaries. The Board has thus looked at a number of holding companies recently to see whether capital could be downstreamed into banks by origination of debt capital by the parent bank holding company. The Board similarly has been concerned with management at the holding company level and by diversion of management talent resulting from the acquisition of nonbank companies without competent management, especially when such companies were of the type not formerly managed by the holding company. It has recently become apparent that such nonbank subsidiaries can be a major problem for a bank holding company.

The problem associated with real estate investment trusts, advised by bank holding companies, as well as problems created by direct loans by finance and other nonbank subsidiaries, have surfaced questions of the effects on bank subsidiaries of the same company. In a few cases there have been attempts to transfer paper between a troubled nonbank subsidiary to a bank subsidiary by means of corporate transfers and sales and purchases of investments. Of course, such transfers are severely limited by the Federal Reserve Act but in a few cases the transfers were made over and above the limits in the Act, creating a violation. As a result of these problems, the Board has been studying means by which early warnings can be achieved of problems in the nonbank subsidiaries--problems which might spill over to threaten the solvency, liquidity, or soundness of the holding company and its bank subsidiaries. A new report on inter-company transfers has been developed which will provide some of the information needed to monitor such transfers. The Federal Reserve Banks and Board of Governors have not set a course, as yet, on examination of nonbank subsidiaries, though the Reserve System units have done a substantial number of inspections. Some of these inspections have been to determine the general health and condition of a bank holding company; others have been made because some particular problem about a company or nonbank subsidiaries became known to the System.

Looking down the road to the future issues which we can perceive, it is rather clear that the early identification of problems will be a primary regulatory effort of the Federal Reserve. The resolution of such problems will depend to a large extent upon early identification followed by creating procedures which will screen these problems from the bank subsidiaries. It may be that the Federal Reserve will need additional legislative authority to force divestment of nonbank subsidiaries where such subsidiaries are in significant trouble and are threatening the safety and soundness of the bank subsidiary.

A recurring issue, but one which seems likely to be significant in the coming years, is the level of concentration to be permitted in each banking market. If the Federal Reserve continues its present pattern, there will be limitations on such concentration and the limitations are likely to be challenged by bank holding companies and perhaps even individual banks. The concentration ratios by market and by State are sharply divergent, as past legislation has permitted some major companies to achieve great concentration of deposit holdings while others, particularly in unit bank States, have been held to relatively modest ratios.

In my opinion, the Federal Reserve will increase its emphasis upon the convenience and needs and the measurement of public benefits to be achieved by further acquisitions by the major holding companies. As banking markets develop and additional offices are available to the population, it may well be substantially more difficult for a multibank holding company to prove that its acquisition of a bank is in the public interest by providing greater competition or providing services not presently rendered to the public. Similarly, in my view, there will be additional scrutiny by the Board of Governors on cases where the public benefit cannot be clearly established but instead is simply to benefit an individual. Also, it seems to me that the Board will be looking with considerable interest at its prior position that virtually unrestricted de novo entries are pro-competitive. In line with my comments above, it would seem to me that as banking markets become saturated, a de novo entry might be a problem to that market, limiting the growth and perhaps even challenging the profitability of existing banks.

Moreover, it seems to me, that the Board will be looking at its laundry list, possibly to permit expanding into other non-bank fields, but within very limited areas. In fact, proposals to find as permissible additional nonbank activities may take much less time in the coming years than in the past years.

With regard to the problems and regulation of holding companies after they are established, it seems to me that one of the principal needs will be to ensure that the bank, nonbank and holding company expansion itself does not lead to problems which cannot be determined within early identification times. Regulation of banks and bank holding companies has already caused the Board to request legislation to permit the thirty-day waiting period to be waived and to permit emergency interstate acquisitions of large problem banks. It is likely that the Board will request changes in penalties to enforce the Bank Holding Company Act, because we have found that sheer voluntary compliance, even with the threat of denials for future applications, is insufficient to correct some of the abuses showing up either in the holding company or in its subsidiaries. In my opinion, the Board will be faced with decisions which raise questions about the protection of independent banks as the banking markets become more saturated. Such protection would be aimed primarily at market area protection and certainly with no attempt to diminish competition.

Similarly, I think the Board of Governors will be faced with limiting expansion-minded companies to those acquisitions which can be handled within the capital and managerial resources of the bank holding company. I believe there will be greater limitation on use of interest-sensitive purchased money liabilities for these companies and perhaps greater limitation of debt to be issued for acquisitions, unless the earnings of the company clearly can justify the issuance and repayment of the debt within its maturity schedule.

Finally it is my belief that the Board will be faced with an increasingly difficult group of application decisions. In only a few States have holding companies made no major efforts and these are largely States prohibiting them, but multibank companies are not very active in the State-wide branching States. As structural questions persist, there may be a new rash of applications to beat legislative challenges. For the Board, the problem will be to watch the concentration of assets and further competition so as to insure the public interest in the best available banking services. As the primary candidates for acquisition are exhausted, the movement may slow, leaving independent banks in the less desirable areas. It will be a problem for the Board to watch carefully that such small banks are not backed into an isolated situation where economic pressure can force unprofitable operations or an uneconomic sale of the bank. Undoubtedly there will be changes in correspondent patterns as holding companies expand, but one can hope that the correspondent services would still be available to the independent banks even if such banks are competitive with subsidiaries of the holding companies.

In summary, the Board and the Federal Reserve, charged with supervising the holding company area, have faced a number of challenging questions in regulation of this Act. We will look with great care, and in fact are already studying, the whole holding company movement, measuring the public interest and efficiency of such holding companies. Without prejudging that study and its results, let me just say that holding companies appear to be accomplishing some of their expected benefits to the public, but they are also creating some unexpected problems as they explore the best method to manage substantially larger and more complex companies with both bank and nonbank subsidiaries.

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