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THE FEDERAL RESERVE AND THE BANK HOLDING COMPANY

Remarks of

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It is widely recognized today that the bank holding company has become a significant factor in the evolution of the American banking system. Its contribution has been through the enhancement of the capacity of many American banks to extend their service areas both geographically and through a broadened range of financial activities and conveniences. The Bank Holding Company Act offers banking a number of entrepreneurial incentives and corporate opportunities. Some are available for the first time in banking history.

Certain critics of bank holding companies believe the undeniable corporate advantages given such companies are disproportionate to the limited public benefits growing out of the expansion of authorized activities. And an even more serious criticism is that lead banks and other banking units in holding company families are exposed to credit and liquidity risks as a result of their affiliation with holding company non-bank subsidiaries such as finance companies, mortgage banking, leasing companies and the like. The extent to which these apprehensions are justified cannot be known for certainty at this time. The financial history of our time when it is written will show whether banking prudence and wise regulatory policies and judgments were exercised today.

Deprived of historical perspective, I believe we should consider the essential role of banks and bank holding companies in light of their ability to fulfill two functions: first, to provide secure depository institutions for a community's money and savings with adequate service and compensation to depositors and, second, to act as intermediary vehicles channeling funds needed to meet the community's credit needs. To a degree, greater effectiveness in one of these functions may be at the expense of less effectiveness in the other.

Forty years ago when public confidence in financial institutions was indeed fragile, a Chicago banker advertised his institution as 100 per cent sound. He assured depositors that their money would be backed up, dollar for dollar, by cash and short-term government securities. For this claim he was known as "100-per-cent Nichols." While his competitors, holding a mere fourth of their assets in governments, derided his institution as a non-bank-safe-deposit-vault operation, he certainly had an accurate appraisal of the pervading public wariness of banks and banking.

It has taken several decades and numerous changes in government support and supervision of financial institutions to rebuild confidence in the banking system which had been so seriously undermined by the bank holiday and the events preceding it. For a time, that rebuilding process went on at the sacrifice of the full potential flow of bank credit for the community and a considerable smothering of competition among financial organizations. For example, it was not until about 15 years ago that the banking system's holding of government securities began to reflect the fact that depositor confidence had been re-established and that their funds could be more actively used to service the private credit needs of individuals and businesses in their service areas.

Today, the banking system serves a broader spectrum of the U.S. economy than it did 10, 20 or 40 years ago. The most conspicuous single user of bank credit today is the non-financial business community, including agriculture. Commercial, industrial and agricultural loans amount to about 26 per cent of the banking system's net assets (total assets less cash and due-from banks).

Governments--Federal, State and local--are banking's second largest category of credit customers. Investment in Treasury and agency securities amounts to about 11 per cent. State and local securities account for 13 per cent; the total is comparable to that for businesses.

Banking's third largest category of customers is made up of consumers. Loans to individuals amount to 14 per cent of net assets and if residential mortgages are included, the bulk of which are on one-to-four-family dwellings, consumers' share of bank credit rises to 24 per cent.

In thus accounting for the use of three-fourths of bank credit we have gone about as far as our statistical classification permits. Another 6 per cent in loans can be allocated to financial institutions and an additional 6 per cent to mortgages other than residential (churches, hospitals, and other community facilities as well as business facilities) but further specification involves classification uncertainties and relatively insignificant uses of bank credit.

The diversification in the use of bank credit has become a major characteristic of our banking system. The trend toward such diversification is continuing and I believe that it makes for more responsive financial services and adds to the economy's capability. The past year has posed difficult problems for the nation's financial institutions, but in general these problems have been those of their customers for many of whom banks are lenders of last resort.

I see no inherent reason why the greater breadth of holding company activity should weaken the integrity of our banking system. The contrary result was anticipated by Congress in providing regulatory safeguards in the 1970 amendments to the Bank Holding Company Act. Weaknesses and deficiencies have shown up but I believe their most likely causes will be found to be attributable to entrepreneurial abuses and regulatory myopia.

As we are all faced in greater or lesser degree with the problem of appraising the role of bank holding companies today, I believe we should focus attention on their effect on banking structure, on financial services and on institutional stability.

Recent changes in the American banking structure show most clearly one of the consequences of the widespread use of the holding company form of organization. In the pre-multi-bank holding company era the several States opted for one of three types of banking structure: unit banking with no branches; limited branching confined to the home office city, county and, in some instances, contiguous area; and statewide branching. The holding company has had almost no structural impact on jurisdictions where statewide branching prevails such as the

West Coast, the inter-mountain region and certain States along the eastern seaboard, notably the Carolinas and Maryland.

Since multi-bank holding companies are not authorized in several unit branching States, notably Illinois, Kansas, Nebraska and Oklahoma, and in such limited branching States as Indiana, Kentucky, Louisiana, Mississippi and Pennsylvania, the influence of the holding company concept in these States is apparent only from the intense pressures generated in certain of them to authorize multi-bank holding company operations in the near future. One-bank holding companies are found in all or virtually all States.

In contrast, those unit and limited branching States which have authorized multi-bank holding companies have seen a dramatic change in their banking structure during the past four or five years. These States are New Jersey, Virginia, Florida, Alabama, Tennessee, Massachusetts, Maine, Missouri, Texas and Colorado. In most of them there are at least a half-dozen holding companies several with representation in many, if not all, major markets in the State. The number of holding companies in these States changes frequently but by a mid-1974 count, there were 34 in Florida, 25 in Texas, 22 in Missouri, 12 in Massachusetts and Virginia and 10 in New Jersey and 8 in Alabama, Tennessee and Colorado. In terms of statewide banking markets, the holding companies as a group had market shares ranging from 50 to 75 per cent of State totals.

In the States of New York, Connecticut, Michigan, Ohio, Wisconsin, Minnesota and Iowa the holding company has accommodated extension of existing banking interests to additional banking markets within the State and has brought new banking affiliations into existence. These changes have been unfolding more slowly primarily because of the inherent stability in existing banking structures. In several cases, notably Minnesota, Wisconsin and Ohio, holding companies grandfathered from pre-1956 days have expanded further and several new companies have been formed. Four grandfathered companies in Minnesota compare to seven today. One surviving company in Wisconsin is augmented by 18 today, and one in Ohio compares to 14 today.

Holding companies in States where they have been authorized have fostered organizations capable of offering banking services on a statewide basis. By doing so they have broken down local concentrations of banking power through de novo or foothold entry or if a large or dominant local bank has been acquired, these institutions have, on occasion, been a vehicle for bringing into the community service standards for depositors and loan customers previously not locally available.

While the lead bank in most holding companies is a large or even dominant bank in its home territory, the formation of holding companies and their expansion under the policies of the Federal Reserve Board has been channeled in the direction of improving the competitive environment in the several banking markets within a State. An effective banking competitor has to be large enough to achieve economies of scale, provide entrepreneurial and managerial opportunities, to attract capital and to make money in a competitive environment. There is such a thing as diseconomies of size, too; these occur when managerial foresight and control are unequal to the complexities of sheer bigness.

For the most part, the pattern of holding company development has included many intermediate sized organizations, compared to the footings of large statewide branching systems. Almost without exception, holding companies have strengthened capital, managerial and internal controls in the banks they have acquired. The typical holding company also relies on a greater delegation of operating and lending responsibilities than is typical of branching systems. Thus, so far as banking structure is concerned, the holding company may contain the best of the two patterns of banking development in the U.S.--unit and statewide branching--in the form of ingredients of local autonomy and understanding on the one hand and the efficiencies and competitiveness of size on the other.

I have relatively little to say about the extension of banking services through the additional powers given holding companies. Purely service activities such as data processing, acting as a trust company, an investment or financial advisor, as an insurance agent, as an underwriter for credit, life, accident or health insurance, issuing travelers checks, providing courier services and so forth, have generated considerable opposition from non-bank interests. However, participation in these and similar activities seems to me clearly to have been procompetitive and to have resulted in gains for the public interest.

Ventures into mortgage banking, consumer lending, business finance, leasing and other credit granting activity which leverage operations directly or indirectly through the holding company organization raise an entirely different set of considerations. Applicants seeking entry into these businesses have uniformly voiced the view they can provide and maintain a more diversified and higher level of services than non-holding-company affiliated concerns. Some say they can do it for less. They have stressed access to equity and loan funds at lower prices and improved availability by virtue of membership in the holding company family.

These claims have yet to be thoroughly tested. But since both affiliated and non-affiliated leasing, mortgage and finance firms abound, there will, in time, be no lack of empirical evidence to confirm or discount these expectations. In the meantime, this is an issue on which I would suspend judgment.

The question on which judgment cannot be reserved or deferred is whether the bank holding company is contributing in any significant way to weakness or instability in our banking system. Before totting up the pros and cons on this issue, I should make clear that I am not seeking a judgment which will tolerate no exceptions. There are bound to be instances in which the holding company by reason of manipulation or mismanagement can cause instability both in the lead bank and in the affiliated banks. Such exceptions can be expected in any institutional arrangement. The question is one of inherent weakness or overexposure to abuse.

As bank holding companies expanded their interests into ownership of consumer and business finance, leasing, and mortgage companies and have used the commercial paper market to provide financing of these activities, more and more questions have been raised about leverage and liquidity exposure for such subsidiaries. These apprehensions have grown with the downturn in economic activity and distress in real estate markets.

The earlier phase of apprehension had given rise to two theories about links within the bank holding company family. One concept is that since members of the family are legally independent and operationally severable, the credit standing of each family member is also a severable characteristic. A wholly owned subsidiary could under this theory fail and be liquidated with losses to creditors for borrowed funds without serious consequences to the credit standing of the parent or other family members. The thrust of this argument is that the viability and soundness of the banking members is determined by the soundness and viability of the banking institutions themselves and is unimpaired by credit problems of non-banking members.

The concept of severability is said to be reinforced by physical separation of sites from which banking and non-banking operations are conducted and by distinctively different corporate names. It is further urged that if the conventional limits on leveraging established for non-holding-company-affiliated concerns were observed for affiliated concerns, this would lend additional weight to the concept of severability and strengthen the expectation that each member of the family has an independent severable credit status.

The second and opposing concept is that so far as credit standing is concerned, there is no such thing as severability in a family of financial institutions whose members solicit deposits and borrow in the nation's money and banking markets. The family name is built on confidence in the credit integrity of all of its members; one of them cannot default on its obligations without jeopardizing the integrity of the others.

Banking history and contemporary banking practice both at home and abroad is replete with illustrations of the lengths to which banking institutions will go to protect their credit standing. It is not a question of the legal ability to avoid meeting outstanding financial obligations; it is not even a moral or ethical issue in the final analysis. It is a question rather of survival as a financial institution in a world where confidence more than anything else determines the access of such intermediaries to the liquid funds of savers and investors.

As between these two concepts of financial responsibility, I believe there are several reasons for preferring the concept of non-severability. The main reason is that it is in accord with established practice. There may be cases in which obligations have been shucked off but few if any have escaped the attention of the financial community which sets this standard of behavior. Of course, obligations have been defaulted by discredited or deposed managements and boards of directors; these are actions *in extremis*--not those of an institution that expects to continue in business.

The other major reason for preferring the latter concept of holding company family responsibility is that acknowledgement of this responsibility has a sobering effect on acquisition policy and on parent company surveillance of the operations of its subsidiaries. If the bank holding company in the United States is to achieve the role in banking measured by its potential it will never do so, in my opinion, by taking flyers in this or that venture and sloughing off the responsibility for the credit obligations of these family members.

A bank holding company should be regarded as something of special character and well outside of the pattern of contemporary conglomerates and of the numerous and questionable leveraging or control devices used by utility holding companies in the past. The bank holding company proper should have the ability to strengthen the financial structure of its subsidiaries--bank and non-bank--to ensure and extend the services they provide, to add to their competitive effectiveness and thus to improve fundamentally the operation of our entire financial system. To accomplish these purposes, the "family" must be one for all and all for one.

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