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Statement by

J. Charles Partee

Member, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

July 1, 1980

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I am glad to appear today before this Committee to present the Federal Reserve Board's views on two banking bills that have been the subject of much attention and previous debate. One would limit the insurance activities of bank holding companies. The other would subject acquisitions of banking organizations to stricter standards than in the present anti-trust laws and would tighten the rules for expansion into nonbanking activities by bank holding companies.

The proposed H.R. 2255 would prohibit the sale of credit related property and casualty insurance by bank holding companies with consolidated assets in excess of $50 million, with certain exceptions.

The exceptions are:

(1) The sale of credit life, personal accident and health insurance,

(2) The sale by finance company subsidiaries of BHCs of property and casualty insurance on property used as collateral for a loan of $10,000 or less, indexed to future increases in the consumer price index,

(3) The sale of general insurance in places of 5,000 population or less, or where the Board determines that insurance agency facilitiies are inadequate; and

(4) The sale of insurance pursuant to certain limited "grandfather" rights for organizations engaged in the activity prior to June 6, 1978, and a limited authority to continue to act as "managing general agents" with respect to insurance on real and personal property and group life insurance for the banking organization and or its employees.

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The Board consistently has opposed this bill because it seems to us to be anticompetitive and discriminatory. Many creditors, including finance companies and retailers, are permitted to sell insurance in connection with their credit granting activities, but the proposed prohibitions would apply only to bank holding companies. In this respect the bill clearly discriminates against customers of BHCs because the finance company, retail and other sectors would remain free to offer property and casualty insurance. The bill also may be misdirected, since the available evidence suggests that any abuses are more likely to occur among nonbank lenders than in banking. A similar inconsistency exists in that the evidence clearly indicates that potential abuses associated with the joint offering of credit and insurance are more likely to occur in the sale of credit life than in the property and casualty field. Yet, the proposed legislation allows credit insurance but prohibits the sale of credit related property and casualty insurance.

The various exemptions also seem inconsistent with the purposes of the proposed bill and would appear to compound the inequities. The Board opposes both the $50 million asset size exemption and the $10,000 transaction exemption for subsidiary finance companies. Permitting an activity to be engaged in by a bank holding company or its subsidiary solely because of the asset size of the bank holding company or the size of the transaction involved are not relevant criteria to determining whether an activity is "closely related" to banking. By employing such a standard, Congress would be abandoning some well established criteria that have

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been developed over the years by the courts and have come to be recognized as appropriate for determining whether a nonbanking activity is "closely related" to banking within the meaning of section 4(c)(8) of the Act.[1/] In addition, the effect of the $50 million asset size exemption would be to permit expanded sales of insurance by small bank holding companies. The majority of these companies is located in relatively concentrated markets where the potential for abuse is greatest since we would submit that market power is generally related to the relative rather than the absolute size of the organizations in such markets. In addition, the effect of lifting constraints on the scope of insurance agency activities for small bank holding companies and exempting finance company transactions of less than $10,000 probably would be to increase the volume of insurance sold by holding companies. In fact, over 60 percent of all bank holding companies would be able to expand the scope and volume of their activities to include transactions clearly unrelated to banking. This appears directly contradictory to the intent of the bill.

The Board's view continues to be that banking organizations should be allowed to sell credit related insurance, including property and casualty insurance to protect loan collateral. There are several reasons to believe that the benefits of such activity outweigh the possible adverse effects. First, permitting banks and bank holding companies to provide these services is likely to be pro-competitive. Second, sales of insurance by subsidiary banks provides a useful and convenient service to the public, including sales at locations

1/ National Courier Association v. Board of Governors, 516, F.2d 1229, 1237 (D.C. Cir. 1975), Alabama Association of Independent Insurance Agents v. Board of Governors, 533 F.2d 224, 241 (5th Cir. 1976), and NCNB Corporation v. Board of Governors, 599 F.2d 609 (4th Cir. 1979)).

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which may be poorly served by others. Prohibiting the activity for larger banking organizations would surely inconvenience at least some of the public--namely those borrowers who would be forced by the prohibition to look elsewhere for the needed insurance coverage.

Before commenting on specific provisions of S.39, the "Competition in Banking Act of 1979", it may be useful to make some general observations. Governor Coldwell testified before this Committee in 1978 and I testified before the House Banking Committee last year on these same proposals. In both cases we indicated that the Board sees no need for additional legal restraints on the already closely regulated expansion by banking organizations.

First, there has been a noticeable trend towards deconcentration of domestic banking resources at the national level, as well as in many states and local markets. Most of the growth that generated concern about increased concentration in U.S. banking actually took place in the foreign sector. This growth masked the trend toward deconcentration of domestic banking assets while it actually represented an improvement in the competitive position of U.S. banking organizations in foreign markets.

Second, bank holding company expansion in the nonbanking area has been strictly controlled. Only those activities that are closely related to banking and are a proper incident thereto have been authorized, and expansion has been mainly de novo rather than by acquisition of existing organizations. This form of expansion has been procompeti-

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tive and, on balance, has brought benefits to the public. In our judgment, the flexibility of the present regulatory system serves the nation well and will continue to provide an appropiate regulatory framework for expansion of the financial sector.

I might add that passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 has the potential for enhancing the competitive structure of banking markets for many financial services, both for depositors and loan customers. Its passage should further alleviate many of the concerns about concentration reflected in S.39, and the increased competition in banking markets that will result should act as an additional deterrent to potential abuses of market power.

The Appendix to my testimony sets forth the positions of the Board on the specific provisions of S.39, except for Section 601 which I would like to discuss briefly. The Board strongly objects to the additional hearing and administrative procedure requirements contained in this section.

Under Section 601 the Board could be required to provide an adjudicative or trial-type hearing in nearly every 4(c)(8) application or rule-making proceeding, whether or not there are disputed facts involved. This represents a step backward to the underlying burdensome and time-consuming procedures of the Bank Holding Company Act prior to the 1970 Amendments. The courts and other administrative law authorities have long recognized the distinction, established by the Administrative Procedure Act, between adjudication and rule-making. Adjudication and a formal hearing may be required to establish disputed facts about particular parties, their activities, businesses and property.

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On the other hand a rule-making procedure is less formal because the issues do not typically relate to disputed facts. The precedents in administrative law demonstrate that the public interest is safeguarded and best served in rule-making by avoiding the cumbersome and unreasonably lengthy procedures of formal adversary hearings.

Recognizing Congress' imposition in 1970 of a time limit on the processing of 4(c)(8) applications, the Board has successfully accelerated its decision-making process using a variety of procedural tools consistent with the Administrative Procedure Act. These include a formal hearing where there are disputed questions of fact. We feel that these procedures assure that the best possible, informed, decision is made in the shortest period of time. Accordingly, we would strongly recommend that the present procedures be continued.

In closing, I would like to sound a note of caution. Our economy and financial system are changing rapidly. Demands for financial services are increasing even faster and new techniques are making it possible to meet such demands in increasingly efficient and innovative ways. In this rapidly changing environment we believe that adding to the rigidities of regulation would be a mistake. The present regulatory framework, while not perfect, has sufficient flexibility to adapt as necessary to changes in technology and services offered—a flexbility that needs to be preserved if the public is to continue to be best served by our evolving financial system.

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Appendix
Board Positions on Proposed Provisions of S.39
Not Discussed in Testimony

The Twenty Percent Limitation

One of the provisions of the bill establishes an outright prohibition of any bank merger or holding company acquisition of a bank in which the resulting company would control more than 20 percent of the banking assets in any state. The one exception would be where the proposed acquisition is necessary to prevent a bank failure and no lesser anticompetitive alternative is available. The Board seriously questions the desirability of such an absolute limit, especially in view of the wide differences in state banking structures and a lack of evidence that concentration is generally increasing at the state-wide level or in local markets. The Board is particularly concerned in those situations where modest foothold acquisitions or de novo entry would in fact tend to deconcentrate local markets and where such deconcentration would be prevented by this particular provision. It also would be misleading and inequitable to base the percentage restriction on total assets, rather than on those domestic assets generated from the local markets or the state. Large banking organizations, for example, have tended to concentrate during recent years on the growth of their national and international business, and in at least some cases their share of domestic business in local markets has decreased. The effect of the arbitrary 20 percent limitation would be to penalize those banks that had a significant portion of their assets outside

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the state or U.S. and thus has little relevance to concentration or competition in local U.S. banking markets. In the Board's view, federal imposition of such a rigid overall constraint would interfere with the rights of the states to decide what type of banking structure best meets their particular needs. Finally it would also deny the Board and other agencies the needed flexibility to take into account unique competitive structures and other local factors associated with the given state. These would include the number and size distribution of competiting institutions, restrictions on geographical expansion, the extent and strengths of nonbank competition, and the general economic environment in the state.

Despite the Board's concern with the bill's asset limitation, there are other provisions pertaining to bank mergers and holding company acquisitions of banks which would provide useful clarifications of existing law. In particular, the Board favors those provisions which would permit denial of acquisitions even when the level of the possible anticompetitive effects do not constitute a violation of the antitrust laws, [or the 20 percent limitation], if the responsible agency believes that the proposed acquisition would not be in the public interest and the anticompetitive effects are not clearly outweighed in the public interest by the probable effect of the transaction in meeting community convenience and needs.

Mandatory Consideration of Relative Economic Size and Market Power

The addition of the mandatory consideration under Section 4(c)(8) of the disparity in size and economic power between the applicant organization and those firms engaged in the subject activity is presumed to focus attention on the potential for predatory economic

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behavior. But the Board believes that any application involving such behavior could and should be denied under the present law's "unfair competition" or "undue concentration of economic power" criteria. The addition of the proposed size disparity criterion would tend to shift the analysis away from the competitive effects in markets to a focus on institutions, and this could prove counter productive to the public welfare.

Tightening of Standards for Section 4(c)(8) Acquisitions

Another feature of the bill is that it would tighten the "closely related" and "public benefits" standards for acquisitions of non-banking activities by bank holding companies under Section 4(c)(8) of the Act. The "closely related" test now contained in Section 4(c)(8) requires that a proposed activity be "so closely related to banking or managing or controlling banks as to be a proper incident thereto." In contrast, the new standard would require that a proposed activity be "so closely and directly related to banking or managing or controlling banks as to be a proper and necessary incident thereto." It is not clear what these additions would mean for the "closely related" test. One possibility is that it would limit permissible 4(c)(8) activities to "banking activities", that is, activities in which banks themselves generally can engage. If so, the existing list of permissible activities would be largely unaffected, since banks can now engage in all but two of the present 4(c)(8) activities, including such important ones as mortgage banking, consumer lending, leasing, factoring and data processing. But there are other possible interpretations of the proposed wording changes in the "closely related " test, and these different interpretations could have significantly different effects. The Board believes that it

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is important to draft any wording changes in the "closely related" test so as to eliminate subsequent controversy over the meaning of the test.

In addition to the "closely related" test, the Act also requires that a proposed activity must "reasonably be expected to produce benefits to the public that outweigh possible adverse effects." The proposed bill would modify the requirement so that the activity "is likely to produce substantial benefits to the public which clearly and significantly outweigh possible adverse effects." The specific factors to be considered in determining substantial benefits and adverse effects would also be expanded.

The Board believes that the changes in the proposed "public benefits" test are unclear. More importantly, we are concerned that the proposed public benefits test would not serve the public as well as the existing test. Under the proposed new test, the Board would have to deny non-banking applications even if the benefits were positive but less than "substantial", or even if substantial benefits would only slightly outweigh adverse effects. The Board can approve such applications under the present standard, and we see no reason to deny the public the opportunity to derive benefits when there is a reasonable probability that these benefits, on balance, will outweigh any adverse effects.

The proposed legislation also expands the adverse factors enumerated in the Act by "risks to the financial soundness of a bank holding company or its banking subsidiaries" and "interfering with the primary responsibility of a bank holding company or its bank subsidiary to provide effective banking services to the public." The bill also specifies that the Board shall require bank holding companies and their subsidiaries to be capitalized and otherwise financed in a safe and

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sound manner. These objectives certainly cannot be questioned. However, the Bank Holding Company Act already requires the Board in bank acquisitions to "take into consideration the financial and managerial resources and future prospects of the company or companies and the banks concerned." Similarly, Section 4(c)(8) of the Act requires the Board to consider such possible adverse effects as unsound banking practices in nonbank acquisitions. In carrying out both of these charges, the Board carefully considers the capitalization and overall financial condition of the holding company and its subsidiaries. Furthermore, as part of its ongoing responsibilities for supervising bank holding companies, the Federal Reserve conducts inspections of the parent companies and their nonbanking subsidiaries, examines subsidiary banks that are state member banks, and reviews the examination reports of other subsidiary banks that are examined by either the Comptroller of the Currency or the FDIC.

With respect to financial considerations, the Board has long held to the philosophy that bank holding companies should serve as a source of strength for their subsidiary banks. In some instances, the Board has obtained commitments from holding companies to supply additional capital to their subsidiary banks and has urged that nonbank subsidiaries be adequately capitalized. In 1974, when certain banking firms began to experience sharp increases in problem loan situations, the Board instituted a "go-slow" policy with respect to further expansion. Consistent with this policy, the Board denied a number of applications, some for the nation's largest banking organizations.

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With respect to the effects of expansion under Section 4(c)(8) on the provision of effective banking services to the public, most of the activities approved are specialized lending functions which could be performed within the bank, but are carried out more efficiently through a specialized nonbank subsidiary. The few activities approved which are other than specialized lending functions, such as data processing or credit life and disability insurance underwriting, are complementary to lending and would seem likely to enhance rather than interfere with the provision of effective banking services to the public.

On balance, it is the judgment of the Board that the addition of these two considerations to the list of adverse factors to be taken into account are not necessary and would not improve the regulatory process.

Mandatory Publication of Intra-Company Transactions Information

The bill contains a provision that would require each bank holding company to submit to the Board each year a report detailing the terms and conditions of all intra-company loans and investments. Moreover, the Board would be required to make such reports available to the public. The Board does not believe these provisions are necessary.

First, the Board is already receiving an intra-company transactions report on a quarterly basis from medium and large size bank holding companies. Second, bank examiners carefully review transactions between bank subsidiaries and the rest of the holding company system, and the Federal Reserve now periodically inspects the financial affairs of parent companies and nonbank subsidiaries. In the Board's judgment, these examinations and inspections, along with existing reports, are sufficient to supply the supervisory authorities with needed information on intra-

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company transactions. In addition, the potential reporting burden associated with such a proposal would be substantial, especially since most intra-company transactions individually would not be material.

Prohibition of Preferential Financing of Non-bank Subsidiaries

The bill also specifies that the Board require bank subsidiaries to refrain from discriminating in favor of their parents or affiliates in making loans or in establishing terms and conditions of credit. The Board agrees that the practices referred to are improper if the terms or conditions of the loan are more favorable than the bank would make to a non-affiliated borrower of comparable creditworthiness. But we oppose the provision with respect to the making of loans to subsidiaries which could have the effect of unduly restricting the flow of funds within the holding company organization. At present, bank examiners closely review bank loans to affiliates and will criticize a loan to an affiliate made on preferential terms that are adverse to the bank. It should also be noted that bank loans to holding company affiliates are covered by Section 23A of the Federal Reserve Act. This Act places quantitative limitations on such loans, as well as requiring that all loans be fully secured by high grade collateral. Indeed, the collateral requirements on bank loans to affiliates are more stringent than collateral provisions on bank loans to non-affiliated borrowers. The Board feels that a better way to deal with transactions involving intra-company fund flows is through Section 23A. In this connection, a new proposal to revise, modernize and strengthen Section 23A was completed and transmitted by the Board to this Committee last year.

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Prohibition of National Banks to Engage in Activities Prohibited by the Board

In general, the Board believes that the adoption of this section would lead to an inflexible regulatory structure which would not be responsive to the differences between the regulatory concerns relevant to National banks, on the one hand, and nonbanking subsidiaries of bank holding companies on the other. The Comptroller of the Currency has primary responsibility for regulating the activities of National banks and that Office's judgment and expertise should not be subject to a regulatory veto of the Board. This would be the result in some cases since the section provides that a National bank may not engage directly or indirectly in any activity which the Board has determined by regulation or order to be an improper activity for bank holding companies.

Grandfather Provisions

In the event that Congress enacts the proposed prohibition on insurance agency activities in HR.2255, the Board would strongly support a grandfather provision and would urge that the effective grandfather date be the date the legislation was approved by the Congress. In our view June 6, 1978 would affect unfairly a number of bank holding companies. We would suggest the elimination of the prohibition against a holding company increasing to any significant degree the volume of business of its grandfathered nonbanking subsidiary. Finally, we would urge elimination of the requirement that suggests a small bank holding company might have to divest of its activities impermissible to companies in excess of $50 million once it exceeds the size limitation. Both provisions would tend

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to discourage the affected holding company subsidiary from competing aggressively for business and thereby serving as a meaningful alternative to help meet the needs of the public.

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