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SOME REFLECTIONS ON THE NEW BANK HOLDING COMPANY LEGISLATION

Remarks of William W. Sherrill

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Introduction

I am especially pleased to have the opportunity to discuss with you today revisions Congress has recently made in Federal bank holding company law. It is both fitting and important that we should meet to discuss the 1970 Amendments to the Bank Holding Company Act.

This is no ordinary legislation, to be implemented by routine revision of the Federal Reserve Board's regulations. On the contrary, it is my view that in reworking bank holding company legislation Congress has cast a new mold from which a better, more efficient American financial sector can and most likely will emerge. It will be a financial system more in keeping with the growth and increasing complexity of our economy, and -- most important of all -- with a greater potential for service to the public.

It is my view -- and I state it at the outset of my remarks so that it may serve as a backdrop to all that I am saying -- that the nation, the economy and the public will be well served by making optimum use of the opportunity this legislation provides for strengthening and diversifying the resources of our financial system. I am of course giving you my own views, as one member of the Board of Governors of the Federal Reserve System. I do not commit any of my colleagues, or the Board's future actions, by my remarks to you. However, I would hope

that a number of other members of the Board would agree with many of the points I am making.

If what I have just been saying has caused any banker to relax with a warm feeling that he has only to wait for the future to drop its fruits into his lap, he is a banker who would do well to look upon the new bank holding company legislation as a warning that he should consider getting into some less demanding line of business.

I presume to give this warning -- and I take it that only the hardy are still present -- because I am speaking of a far different future. This is a future in which American banking can grow, and improve its earnings -- as I think it can and will -- only in the increased sweat of its brow, working a rocky road of sharper competition. It will operate in the glare of an unblinking search by a sophisticated public for demonstrably better service from all of business, our financial system included.

Let me narrow the focus to one word: competition. It is the stiff wind that blows through all that I am saying today about the future of banking in America. Under the new banking laws I expect it to blow harder than most of you have ever known it to blow.

Let us reflect for a moment upon the overall importance of keener competition. It is vital both in the current context and for the long term.

We at the Board of Governors of the Federal Reserve System are grappling, as are the Congress and the Executive Branch, with an economic dilemma -- an unacceptably high rate of inflation co-extant with an unacceptably high rate of unemployment. We do not have time here today for analysis of this situation, which is seriously hampering a current economic and social progress. But it is clearer daily that an important, probably critical, element of the solution lies in movement to a higher and lasting trend of productivity in the United States. High productivity slows price rises by reducing unit costs. In current circumstances this would make goods and services more attractive to a public that is currently putting a disproportionate slice of its income increases largely into savings. A shift toward a more normal propensity to purchase rather than to save can enlarge sales and raise profit margins, encouraging business to spend for expansion of its capacity to produce. All these add to productive employment, increase real income and help make renewed economic growth possible without renewed inflation.

The master key to unlocking high and rising productivity, as perhaps the most important short term need of the economy, as well as a necessary long term trend, is greater competitiveness in the economy at large.

I favor making vigorous use of the new banking legislation precisely because I believe it brings with it a considerable new potential for increasing the scope and intensity of competition in the financial sector of the American economy.

I do not, of course, imply that the new banking law can of itself inspire economic miracles. But I believe it should be used to take full advantage of its potential.

-- Its potential for bringing new businesses into being;

-- Its potential for widening the financial irrigating capabilities of the commercial banking system;

-- Its potential for strengthening banks through proper association among themselves and with related businesses.

If this is done well our marketplaces are going to witness in the next few years a substantial growth in the number and variety of outlets competitively available to the public to fulfill its demands.

Such is the critical position of banking, as the circulatory system for the financial life blood of our economy in general, that improvements in the usefulness to the public of the banking system, and a sharpening of competition in our financial system, cannot fail to have disproportionate benefits in other sectors.

I would like also to be entirely clear on another critical point with respect to implementation of the new banking legislation. In my view, it is vital to the wellbeing of the American economy as a whole to maintain a clear line between banking and commerce.

Congress reinforced this policy of separation in the 1956 Bank Holding Company Act of that year, by limiting the activities of multibank holding companies to the management and control of banks and closely related activities.

I believe the separation of banking and commerce should be carefully guarded, because the arms length dealing of banks with their customers is the key to sound allocation of credit in our economy. Our banking system, in its thousands of decentralized units, makes hundreds of thousands of separate decisions about the use of bank credit daily. In making these decisions our banks directly and locally allocate the use of credit for the creation of new businesses and the financial sustenance of existing businesses. Our central bank, the Federal Reserve System, has confined itself to actions that supply credit to, or subtract it from, the financial system as a whole. This affects the availability and cost of credit, but leaves decisions as to the particular uses of available credit, at the going cost of credit, entirely up to the judgment of the market place and the loan committees of individual banks.

A fogging of the line between banking and commerce could detrimentally affect the judgment of the managers of our banks in deciding to whom to lend, for what purposes. They could be led by such a development in the direction of making loans on a basis of self interest rather than on the basis of whether, in the judgment of a bank's loan committee, the would-be borrower is likely to make productive use of the money and will repay the loan. It is allocation of credit according to such sound and useful criteria that must be maintained if the American banking system is to continue to be a vital part of the American economy. Consider the alternative: failure by the banking system to perform independently as an allocator of credit. This would very shortly result in a banking system reduced in its functions to bureaucratic paper shuffling, probably

under governmental control. Worse still, the function of allocating credit would become an orphan, with no place to seek a new home except in the halls of government, with all that implies for lessened freedom of economic choice and less economic efficiency in America.

In the remainder of my remarks I want to focus chiefly on two subjects:

-- First my impressions of the implications of the new banking legislation for the future of the financial sector in the United States.

-- Second what I believe are the implications of the new banking legislation for the monetary authorities. I would remind you that the Federal Reserve Board must keep in mind as a backdrop to its considerations the national objectives and the wellbeing of the whole economy. First, however, it will be useful to look briefly at the background of the present legislation.

Why One Bank Holding Company Legislation?

The answer to this question is embedded in the 1956 Bank Holding Company. This Act, by omitting the holding companies with a single bank left a legal and regulatory gap in which, potentially, very great concentrations of economic power could be built -- and in which banking and commerce could not be held at arms length.

The resulting situation was not only subject to legislative correction, but required it if we were to preserve the invaluable checks and balances of a sound banking system serving as financial adviser and agent to a free enterprise business system -- each independent of, while necessary to, the other.

In the late 1960's there was a rush to the one bank holding company format by our largest banks. In urging Congress, on behalf of the Board, to

amend the 1956 Act to include holding companies with a single bank, Chairman Burns noted, in May, 1970, that by the end of 1969, among the nation's billion-dollar banks -- of which there were 51 -- 23 were owned by one bank holding companies. Among these were the six largest banks in the country.

It was also notable that in these circumstances, not only were banks reaching by acquisition into commerce, but that non-banking businesses were reaching, by acquisition of banks, into the banking system. The line between banking and commerce was clearly at stake, and the public interest was heavily involved.

It was due to this consideration that the Board sent to the Congress a Statement of Principles, requesting one bank holding company legislation, stating that banks should not become a part of conglomerate organizations and that the separation of business and commerce should be maintained. But it is significant that the Board's statement, of which I was a signer, and which became a foundation stone of the new law, also said:

> "...consistent with continued growth and development of a dynamic and increasingly complex economy, banks should be granted freedom to innovate new services and procedures, either directly, or through wholly-owned subsidiaries, or through affiliates in a holding company system, subject to administrative approval of entry and acquisitions..."

Implications for Banking

We now have the One Bank Holding Company Amendments to the 1956 Act. With certain limited exceptions, this brings every bank holding company, whether it has one, or more than one bank, under the same law. I will not attempt to review here the grandfather provision, or its many fine points, because you can do so more effectively with your own legal counsel.

Under the new legislation, with its expanded opportunities for the association of banking with related businesses, the chief bank executive forming a holding company faces what may be called a crisis of identity, if no undue stress is placed upon the word crisis. His resolution of this opportunity, disguised as a problem, will influence the nature of the emergent holding company, and, as such decisions multiply, something more important: the character of American banking. The bank executive must decide, at bottom, whether he will continue to regard himself as a commercial banker in the traditional sense, or as something significantly different -- a bank holding company executive.

If the chief executive of the single or lead bank in the bank holding company continues to regard himself as the same commercial banker he has always been, his holding company will be operated as an essentially static concern: acquiring deposits and lending money. In short a passive organization responding to demands made upon it by the public.

On the other hand, the chief executive of the group who regards himself as not merely a lender with some new subordinate interests, but as a leader having new and innovative functions, will develop his organization quite differently, and with quite different future implications for users of the financial system in our country.

This situation can be described -- and should be so described and considered at this time, I think -- in the form of a question:

> What will you consider to be the banking of the future, the present banking business organized in multi-corporate form, or, a new and different business, growing from the cocoon of the old commercial banking system?

In short, are we upon the threshold of an evolution of the financial sector in which there is an expanded view of the banking function, and a new appreciation of its potential?

I believe the time has come to reorient our concept of banking. I think the banking of the future must be more broadly conceived. We must recognize that its function no longer is predominantly lending but must become a concept of greatly expanded financial service to its customers. Lending will always, of course, be an important part of banking. But preoccupation with this function will distract the new banking executive from a clear view of the opportunity to become important to his customers in many other ways.

I foresee a time when financial advice, bookkeeping, budgeting, and financial management information provided to the customer may be much more important in the customer's eyes than the funds you make available to him. And, by the way, probably much more profitable to you.

I mentioned that one of the requirements of the new banking would be leadership. It is apparent that I have described services that the present customers of commercial banking do not know can be available to them from banking corporations. The new banker cannot afford to be passive. He must not only develop the new services for his customers, he must develop them efficiently and then he must educate his customers, because at present too many of them do not know they need or want the new services.

In pursuit of this banking future, oriented primarily to the customer's needs, it seems to me that we shall all be well served by vigorous and imaginative use of the new legislation under which banking's association with financially related businesses can be expanded. I am not sure, for my part, that we have much choice. The force of the surrounding circumstances tending in this expansionary direction is very great. In the interest of ensuring that these forces result in greater, not less, competition and productivity in the American economy as a whole and over both the long and the short haul, a rather rapid evolution of our banking system of the type permitted under the 1970 banking legislation may only give legal validation to a choice between an economy losing and an economy gaining in vitality.

If you are considering forming or expanding a bank holding company you will immediately become involved in a number of other basic decisions. Among them are, what lines of activity to enter, whether to enter de novo or by acquisition of a going concern, and, whether to impose geographic limitations upon the company's operations.

The Federal Reserve Board is on record as favoring de novo enterprises over acquisitions, because setting up a new company increases competition or provides a market place for goods or services which formerly did not exist. Acquisitions always raise the question whether competition and public convenience may be reduced.

As to what lines of activity your planning might center on, I believe this matter would be best covered by discussion of the concerns of the regulatory authority.

Implications for the Regulatory Authority

The basic question for the Federal Reserve Board is: How shall we use this law to serve the public better through increased competition?

The law requires and the Board will require holding companies to enhance competition. Your planning should take this into account as a factor certain to weigh heavily. The new law requires not only that bank holding companies include only enterprises that bear a relationship to banking. The law requires as additional tests that there be benefits in the form of competition and public service that outweigh specified possible adverse effects.

Let me repeat also that while I favor vigorous and expansionary use of the scope provided by the new legislation for the association in holding companies of banking and bank-related enterprises, the Board is on record -- with my full concurrence -- that the separation between

banking and commerce must be maintained. It is the function of banking to serve commerce. This function must not be gainsaid by acquisitions that would cripple the willingness or ability of banks to expand competitive commerce in the community the bank serves. Certainly, banking competition must not be reduced.

What general criteria can you expect to be applied? They can be stated very briefly. They are competition, public convenience, efficiency, and the effects upon banking practices.

We proposed, in January -- less than a month after passage of the new law extending our regulatory authority to all bank holding companies -- ten lines of activities to be regarded as closely related to banking, and thus in general permissible for bank holding companies. Applications within these lines of activity are of course subject to scrutiny on their merits and must pass the tests of net favorable effect upon competition and other public interests.

We expect to propose other lines of activities in the future. But for now the lines already proposed should be considered the ten most likely to succeed. Meanwhile, we have also published forms for registration of new bank holding companies.

We have provided copies for you of our news release of January 25 describing our proposals, and other amendments to our regulations under the new banking law, as well as copies of our registration statement. I will not take time to go into the proposed amendments from the rostrum. Let me just note that the period for

comment on these proposals closed February 25, and through that time some 200 letters of comment had been received by the Board. These indicated general approval for most of the proposals. But we have received relevant comments in three areas -- data processing, leasing and insurance activities -- that point up the difficulties we shall encounter in making decisions.

The Board said in its initial proposals that applications to establish new bank-related firms in lines of activity designated by regulation as appropriate, would be deemed approved unless the applicant were notified by the Board within 45 days after we acknowledge receipt of the application that the Board wishes to analyze the proposal. We are attempting to formulate guidelines identifying circumstances in which we would consider acquisitions of existing businesses by bank holding companies to promote competition, and to consider applying this same 45-day approval procedure to such acquisitions. This formulation is most difficult and is receiving continued attention looking to near future action.

You should note that in the interests of protecting competition and the public interest, we require publication -- in the community that would be affected -- of proposals to establish new enterprises, or acquire existing ones.

Administration of the New Law

I think that what I have been saying indicates the Board is proceeding with all due alacrity to provide the American banking

community with rules and guidelines under which it can begin a constructive expansion of its services to the public. We will try hard to reduce administrative impediments to getting the new law off paper and into action.

It would be the worst form of negation of the intent of Congress in passing this law to set up administrative procedures that would abort its implementation. Nevertheless, our procedures must be such as to keep clear the arteries of competition, and to encourage new and improved services to the public. To that end, we will hold hearings aimed at giving us information and insights with respect to the competitive and public interest aspects of various lines of activities. This information and understanding can be applied in deciding upon specific applications for mergers, acquisitions or establishment of new enterprises. It will be our intent to give due consideration to the views of all concerned, consistent with our responsibilities to the public and national interests. I urge you and others interested to communicate fully your views to the Board, including attendance at any scheduled hearings.

I indicated at the outset of my remarks that I believe the public at large, the national interest and the economy in general will all benefit from the new kinds and greater reach of competition the current banking legislation makes possible. Consequently, we intend that our procedures will permit early and useful implementation of the new law.

I cannot promise that you -- or the bank-related portions of the American economy -- will be more comfortable under the new banking law. On the contrary, I think that bankers and others must now learn to gain increased profits while living in an environment of increased competition, and while conforming to the highest standards of service to the public.

It is the job of the Federal Reserve Board -- and your job -- to see that this is the case. It is my expectation that the result will be -- insofar as this law dealing with the critical financial sector of the economy can help to make it so -- an economy working at higher levels of efficiency and productivity, an economy less vulnerable to inflation, and an economy more effective in providing the American people with greater convenience in conducting their daily affairs, and in providing all of them with steady real gains in their income.

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