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BANKERS
AND THE
BANK HOLDING COMPANY
Remarks of
J E F F R E Y M. B U C H E R
Member
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of the
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BANKERS AND THE
BANK HOLDING COMPANY

The development of the holding company form of banking is a positive event in the history of banking in the United States. It might be said that the 1970 amendments to the Bank Holding Company Act wrote "Enough" to the time since 1933 when public policy toward banking was that of an anxious parent toward an errant child. That is somewhat ironic, since the idea of amending the Bank Holding Company Act took shape in the late 1960's very much in the tradition of keeping banking from getting off the reservation, this time through the gap in the regulatory fence freeing the one-bank holding company from regulation.

The Federal Reserve Board, which had been asked for its advice by the Congress, agreed that the one-bank break in the regulatory defenses against the mixing of commerce and finance was dangerous and should be mended without delay, by making holding companies controlling any number of banks, even one, subject to the same rules. However, the Board went on, in its statement of Principles of February 20, 1969, to look through the immediate problem to larger matters, stating 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, either directly, or through wholly-owned subsidiaries, or through affiliates in a holding company system. . . ."

". . .Bank holding companies should be allowed to enter certain nonbanking areas of activity. . . which would facilitate broader services for the public. . . ."

This, in effect, suggested a much greater charter for banking than had ever been known by those whose entire careers had been under the restraints imposed by the banking reforms of the 1930's. Also, the Board was suggesting that banking should no longer be regarded as a ward of the government, strictly constrained to its financial knitting, but, instead, that banking be encouraged by law to broaden its interests into the field of closely related businesses.

Furthermore, the Board's Statement of Principles suggested a substantial shift in regulatory philosophy. The regulatory outlook that grew out of the banking reforms of the 1930's -- which at least in the public view, were reforms necessitated by bank failures in the 1920's and 1930's -- can be characterized as one of avoidance of risk, with only limited concern for maintenance of a competitive climate. Banking, suffering from rather severe trauma, made no significant efforts to escape from this over-protective regulation for decades. It was not until the 1960's, when the one-bank holding company wave -- and the regulatory response to it by the Federal Reserve Board -- made the currents of change begin to flow in earnest. The Board's 1969 Statement of Principles suggested a resetting of the regulatory compass. In place of the more restrictive regulatory style, the Board, in proposing that banking should be allowed new freedom to compete, stated that in considering whether a particular activity by a bank holding

would be consistent with the public interest, the key should be whether such an activity's benefits to the public would outweigh any potential dangers. Benefits to be weighed against dangers, the statement added

" . . . would include greater convenience to the public, increased competition, and gains in efficiency for the economy generally as well as for the holding company. . . ."

And the potential dangers against these benefits were to be weighed, included

" . . . undue concentration of resources, decreased competition, conflicts of interest. . . and dangers to the soundness of the nation's banking business."

With this, the regulatory needle moved to a new course charted out of concern for the health of the general economy, the modernization and efficiency of the financial industry and the convenience to the public of receiving financial services in a more competitive atmosphere, this to be accomplished a balancing of pros and cons, rather than a simple seeking out of cons, in considering extensions of banking's economic concerns.

I am sure that what I have been saying -- and I am of course speaking for myself only -- to this point sounds to you like the introduction to a speech with which all of you are by now quite familiar -- the fundamental change in the nature of banking brought about by the modernization of the Bank Holding Company Act in 1970. The need for bank management to move away from thinking altogether like bankers, and to think, instead, like corporate managers looking out over a related set of businesses which includes one or more banks would be the main theme.

A very great change has in fact occurred. I have deliberately organized the introduction of my remarks to emphasize, and even to give deeper than usual emphasis, I hope, to these profound changes in the outlook for banking -- and in the outlook of bank regulators -- caused by the Bank Holding Company Act Amendments of 1970. Bank management must indeed, under present circumstances, take on many new attributes scarcely needed by the banker of previous decades, whose business was almost entirely attuned to the profit margin lying between the cost of obtaining funds and the price others would pay to use those funds. It is indeed true that the bank holding company format, as extended by the 1970 amendments, makes a great many bank managers heads of diversified business groups, of which the non-bank parts demand methods, talents and attitudes little known to the banker doing exclusively a banking business.

As one recently come from banking, I am keenly aware that the 1970 widening of banking's horizons was required, that banking needed to become more competitive within and outside its own realm, and that banking as an industry faced the risk of ossifying within the shelter of old-style regulation. Also, as a banker, I was aware before I became a regulator that much of banking was lagging behind the technological and managerial capacities of other businesses, and the industry was therefore in danger of losing its place and share in the American economic scheme of things, to the detriment of our financial system and to the detriment of the public through the weakening of a key competitive force within the economy.

For all these reasons and more, I welcome the expanded role of banking, and I welcome the new orientation of bank regulation that parallels banking's changed status.

Nevertheless, as you have probably guessed by now, I am not here today to expound on banking's new era, or to urge you to step aside immediately for someone fresh from business school, with computer software dangling from his pockets, hardware glinting in his eyes and who can only see the banking part of his corporation as a treasury, somewhat unaccountably hedged about with numerous and bothersome rules.

Let me, therefore, offer you a first word of caution -- resist the temptation to strike your banker's flag the day you become a diversified bank holding company.

You are still first and foremost a banker, in a business strongly affected by the public interest. This is, of course, presently true statistically, for even bank holding companies that have aggressively sought non-bank acquisitions still have most of their assets in banking. But in my view you will be still basically a banker even if the statistics go the other way, and the corporation you manage has the greater part, or a large minority, of its assets in non-bank businesses, because you will still control a bank, or banks. As such you will still be in a business -- you can say it with pride -- that is a public trust, even

if not a public utility. You will still be charged with the special trust of holding and using the public's money. You are therefore at the controls of a business -- banking, in a bank holding company -- that must continue to deal at arms length with the other sectors of the economy, that must be subject to special public accountability and regulation, that has a special role in the nation's monetary posture, that must preserve a special independence of outlook and a special integrity, a private business with essential and unavoidable public considerations.

And now for a second word of caution --

Although the bank holding company amendments of 1970 opened up substantial new opportunities for the addition of non-banking profit-making assets to banking, be wary of the potential pitfalls inherent in diversification. For example, as I review bank holding company cases I am troubled by a sense that too many bankers may be aware only of the opportunities of acquiring assets, and not cognizant enough of the responsibilities they simultaneously accept in connection with management of those assets. I would remind you, in this respect, that in the bank holding company with non-bank subsidiaries, even in subsidiaries closely related to banking, such as mortgage company operations, bankers are dealing with businesses that are, in fact, significantly different from banking in many important

respects. There are, therefore, pitfalls in bank holding company diversification that some have compared to the difficulties resulting from the wave of conglomerate and congeneric business mergers and acquisitions of the 1960's. My point is that, absent planning and deliberate action, successful management of a diverse enterprise, more often than not, requires either sheer managerial magic, astounding good luck, or long, hard, slow learning.

Why do bankers form bank holding companies? Let me recite some of the reasons given recently by a bank analyst:^{1/}

1. To obtain geographic diversification into areas precluded to banks by various State banking laws and by Federal regulation against branching across State lines.
2. To enter closely related areas such as factoring, consumer finance, mortgage banking, and investment management. While these are permitted activities for banks, they could be acquired and could be conducted more easily as subsidiaries of a holding company.
3. To permit issuance of commercial paper at the holding company level.
4. To free remuneration and other benefits and inducements from the banking stigma of low pay, poor plans, etc.

^{1/} George L. Hacker, First Vice President, Blythe Eastman Dillon & Co., address of May 29, 1973

However, this analyst added:

"In my opinion, most banks that formed one-bank holding companies have an albatross around their collective necks. . . . Their reasons for forming the corporation, stated simply, were "everyone else is doing it" or "diversification is the answer to squeezes on bank earnings". . . . The plain facts are that, with exceptions, most one-bank holding companies acquired nothing meaningful either because, with their shares selling at 10 times earnings, it was very difficult to acquire a company whose earnings were being capitalized at 100 times, without substantial dilution, or secondly, bank management, again with exceptions, was nervous with even the thought of owning a computer subsidiary whose president was under 30 and probably had a beard!"

Like the analyst I have quoted, it is not my intent to warn you away from bank holding company acquisitions, but to emphasize that, where angels fear to tread, bankers would do well to be wary. My message is go slow, look well to your footings, remember your obligations as a banker -- your regulator is not likely to forget them -- and, of critical importance in diversifying, remember above all that the major element of success is good management. And of all the things in the business world, good management is the hardest to come by -- or to keep if you are lucky enough to buy it or merge with it -- and the slowest to develop, if you have to raise your own.

Let me, therefore, make a few observations on management as a note of caution to the banker diversifying.

The management problem is not necessarily solved when you find a well-run company that you can bring into your bank holding company.

Generally, the company will have been a medium-to-small organization, managed by men accustomed to making the final decisions, and accustomed to making those decisions upon the relatively narrow basis of the ins and outs of their particular business. As a subsidiary of a bank holding company, even given the maximum autonomy prudently permissible, they will no longer have the final say. Further, their decisions will have to be made in the broader context of the well-being of the entire holding company organization.

For such reasons, excellent management brought into a holding company by acquisition may soon exit because it cannot accommodate itself to the new environment. Or, where a highly successful "mom and pop" type company -- bank or otherwise -- is acquired, the former owners -- having realized in capital gains upon their years of hard labor developing the business -- may relax in their hired-hand status in the holding company, and pay less and less attention to the business their personal efforts made successful.

I would feel remiss in leaving you with these sobering observations, and no suggestions. I do not think the management problem in a diversified company, difficult as it may be, is insurmountable. What is required is patience and a plan. I said at the outset of this section of my remarks that my message was, in part, go slow. In fact, it is in large part, go slow. I suggest that the pitfalls of poor management of diverse businesses in a bank holding company, given the probability that the non-banking businesses in the company are alien territory to bankers at the head of the company,

call for something like a well laid out -- and faithfully followed -- management development program. This should involve building, over time, a management team -- banking and non-banking -- used to dealing with one another, on top of its problems and up to date technically; a team that will have learned how to operate the various parts of the holding company so that each grows and profits, in the setting of the well being of the company as a whole, and particularly, with an eye to the need for preserving sound banking, and serving the public benefit, in the context of bank holding company operations.

This strategy may also mean that you pass up a few potential acquisitions that may come to your attention before your managerial resources are fully developed, or even -- perish the thought -- that you might find it necessary to abstain from expanding de novo.

Meanwhile, during a substantial part of this development period, it is possible that the bank holding company will have to struggle through a learning period that is hard on profits, juicy though the apple of diversification may seem until bitten. This is among the reasons that the Federal Reserve Board, as I am sure all of you are aware, is taking a keen interest in the capital structure of bank holding companies and their affiliates.

What is our objective in taking an interest in the financial structure of bank holding companies? It is the ancient regulatory objective of protecting the safety of bank deposits, and the soundness of the banking system, when that banking system as a whole, and its

individual components, comes under the new exposures to risk involved in diversification under the bank holding company format. In various of its statements, the Board has commented about additions to capital accounts or in other ways indicated its interest in the general condition of the holding company or its subsidiaries, either bank or nonbank. In our review of the financial aspects of bank holding companies that come before us, we analyze prospects, managerial capabilities, earnings, capital adequacy, and debt structure where debt is a significant percentage of net worth. We have set no hard or fast rules and we regard an individual analysis as always necessary. When debt levels of holding companies become large in relation to net worth, the holding company is asked to inform us of the use to which the debt is put, and to demonstrate its ability to continue sound operations while servicing this debt.

What are our procedures in this respect? They may be summarized as follows.

Upon receipt of an application to become a bank holding company, or to expand an existing company by acquiring either a bank or nonbank, the general condition of each bank involved is reviewed. When capital, particularly equity capital, is regarded as below appropriate levels, applicants are asked about their plans for increasing capital. Existing or proposed nonbank subsidiaries are likewise analyzed. It is expected that such subsidiaries will maintain equity capital at a level equal to that maintained by the average firm operating independently of any holding company. While an adequate amount of equity capital cannot alone assure

the soundness of any individual institution -- the element of good management is over-riding -- sound capitalization permits good management to concentrate on viable development of the company.

There are other pitfalls that I could go into, and that concern me as a member of the Federal Reserve Board, when I must consider a bank holding company application. I would take time to emphasize only one other, however, based again on my own background in banking. This is, that as the bank diversifies its interests by acquiring non-bank businesses there is a temptation to seize upon the fair-haired boy of banking -- the commercial loan officer -- as the only candidate considered for promotion to the management of non-bank businesses or the holding company itself. But the loan officer may have become a highly specialized man. Further, the more successful he has been, often the more specialized he has become. Therefore, promoting him to the head of non-bank businesses can have two undesirable results, unless he is a man of truly uncommon depth and breadth.

First, you deprive yourself on the banking side of one of your most needed people, a good loan officer. Since you are still chiefly in banking, and lending will continue to be your primary business, at least for some time, this can have both short and long range undesirable effects upon the success of the entire organization.

Second, the specialized loan officer, with a few exceptions, will find himself untrained, unprepared and unknowing in his new managerial post. Thus your new non-bank unit, at a time when it is imperative that it receive the best in managerial leadership, may not have the benefit of

such leadership. I must point out that I have nothing against commercial loan officers -- as a matter of fact, some of my best friends are of that calling. What I am trying to emphasize is that as proprietors of bank holding companies you may have to make a special effort to think in a different dimension because you find yourself in a new world.

I hope this does not add up to a gloomy picture. It is not meant to do so. The bank holding company has a major role to play in the U. S. economy. It can aggregate financial resources outside the main money centers, and bring strong local financial resources to economic growth areas that now suffer from the many deficiencies of absentee financing.

For this reason alone, I think it is important to encourage sound bank holding company growth. What I have tried to emphasize is that this growth must be sound in the sense, first, that it strengthens the financial services available to the public, makes them more convenient, and supplies new competitive striving for the favor of all who are served by the financial community; second, that the bank holding company is still in the banking business, with its special public responsibilities; and finally, that development of bank holding companies -- individually and as a movement -- should proceed on a go-slow basis that takes its speed limit from the time required to assure sound management, both of the banks and the non-banks in the holding company system.

These are not restraints. They are specifications for strong foundations, from which both the banking community and public will benefit.

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