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Statement by

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before the

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It is my privilege to present the response of the Federal Reserve Board to the FINE Discussion Principles embodied in Title III. Before reviewing the principles and responding to each, however, I would like to present the Board's current assessment of the Bank Holding Company movement as it has developed since the 1970 Amendments. It will be recalled that the Legislation amending the 1956 Bank Holding Company Act was designed (1) to bring one-bank holding companies under the Act, (2) to allow bank holding companies to engage in a broader range of nonbanking activities closely related to banking, and (3) to assure that public needs and conveniences were considered when permitting an acquisition.

The Board believes that the bank holding company movement, on balance, has been in the public interest, if all factors are carefully weighed. We recognize that it may be too early to appraise adequately all the ramifications of the changes in banking structure, the new competitiveness in banking and bank-related industries, and the sufficiency of full realization of the public benefits promised by the applicants. There are some questions on the proper degree of regulatory control, and the permissiveness of the holding company form of organization. But many of the charges of financial trouble levied against the bank holding company movement have little relevance to the form of organization and are primarily the result of broader economic problems and aggressiveness of bank managements policies.

In our view the primary and demonstrable benefit from the holding company movement has been the competitive impact in the banking industry. Through de novo and foothold entries new and stronger competitors have been introduced into local banking markets. There have been 218 de novo banks organized in metropolitan markets by domestic multibank holding companies during the five years since the 1970 Amendments. Of these about 23 percent were opened in markets where the holding company was not previously represented by a bank. Another 45 new banks were opened in non-metropolitan markets. Of these, about 84 percent represented initial entry by the holding companies. These data support our judgment that new banking alternatives have been opened to the public with increased competition for existing banks.

With respect to acquisitions of banks that have small market shares, empirical studies show that the market shares of these acquired banks have increased under holding company control, suggesting an improved competitiveness that perhaps includes broader services. There are less certain but creditable indications of increased competition in state and regional banking markets resulting from the growing abilities of bank holding companies to meet the expanding needs of regional and national businesses.

Competitive benefits are also reflected in the _de novo_ and foothold entries of bank holding companies in nonbanking activities. Since 1970, bank holding companies have established over 1,600 nonbank _de novo_ offices, with consumer finance, insurance, mortgage banking, and leasing firms accounting for more than 70 percent of that total. Also holding companies frequently have acquired small or medium size firms and then expanded _de novo_ into new markets. It is our impression that the new entrants have had a pro-competitive effect in the local markets for such bank-related activities.

Beyond the competitive impacts, I believe that the bank holding company movement has permitted an improved mobilization of funds in the economy by overcoming to some degree, certain restrictions such as branching limitations and barriers to the types of activities in which banks can engage. The reinforcing impact of bank-credit availability and the strength of broader marketing are difficult to quantify but their intangible benefits for the economy are nonetheless significant. Similarly, the bank holding company organization has provided a new vehicle for marketing the stock of small banks and certain nonbanking companies. This benefit could be particularly important in solving the problems of a majority owner of a rural bank who wishes to sell his bank.

Finally, bank holding companies have improved the financial condition and management of many of their newly-acquired banks. Of particular importance has been the provision of additional capital. In 397 separate approvals of holding company acquisitions, the Federal Reserve has conditioned its approval on, or reached agreement with the applicant for, an injection of new capital. Such applicants have provided almost $788 million of new capital as a result of these acquisition agreements and bank holding companies, often after urging by the Federal Reserve, have put in an additional $1,154 million in new capital. In total then, bank holding companies have injected almost $2 billion of new capital funds into subsidiaries. While a part of this total might have been injected without the holding company form or the requirements of the Federal Reserve, it is doubtful that the total would have been nearly so large.

The ability of bank holding companies to provide management for their new acquisitions has been a significant benefit; particularly when the acquired bank had unsatisfactory leadership or faced a management succession problem. Growing bank holding companies are often able to attract new executive talent, thereby enabling them to supply management to newly-acquired or organized banks. Such benefits are very difficult to measure, but we believe that the ability of holding companies to provide management is a substantial public benefit.

The Board also recognizes that there are costs associated with the bank holding company movement. Some bank holding companies have experienced financial problems, but it is important to note that many of these problems have developed in their bank subsidiaries. The majority of these problems would probably have materialized even if the banks had not been an affiliate of a holding company. A significant proportion of these bank problems have stemmed from the recession but others have resulted from overly aggressive bank lending and investment policies.

Some other bank holding company problems, however, have originated in their nonbank subsidiaries. For example, some mortgage banking affiliates have sustained operating losses, and a few have tried to avoid severe distress by selling assets of doubtful quality to bank subsidiaries. Except in rare cases, however, the problems associated with nonbank subsidiaries have not had a major negative impact on bank holding companies. One reason is that these nonbank subsidiaries are usually a small factor in the holding company system. In fact, total nonbank assets of bank holding companies account for less than 5 percent of total consolidated holding company assets.

Another problem area is that some bank holding company-advised Real Estate Investment Trusts (REITs), often carrying the name of the holding company or its lead bank, have encountered financial troubles. Although many independent and bank-advised REITs have experienced similar difficulties, it is probably true that the holding companies were able to pursue this line of endeavor more freely and with greater aggressiveness. Of course, the recession in economic activities has been a major source of these difficulties, but some REITs became exposed to a greater extent than other lenders in the mortgage market.

Use of the bank holding company form of organization has permitted greater flexibility and latitude than the normal single unit bank or even a branch bank system. For example, the ability of holding companies to "double leverage" (that is, raising funds through parent debt issues and downstreaming equity capital to bank subsidiaries) has allowed the holding company to increase the capital ratios of bank subsidiaries, while increasing the leverage of the company as a whole. Problems can develop from "double leveraging" if the parent's debt servicing requirements are such that unduly heavy dividends are required from the bank.

The Federal Reserve is charged with regulating bank holding companies by approving or denying applications for acquisitions, by overseeing their financial conditions, and by insuring compliance with the Act and its associated regulations. When acting upon proposed acquisitions, we have regularly given attention to financial and managerial factors, competitive effects (including any concentration issues), and the public benefits expected. We typically require the applicant and its subsidiaries, both bank and nonbank, to be in generally satisfactory financial condition. In a number of cases, as noted above, we have required additional capital and other corrections as a condition for approval. The Federal Reserve closely scrutinizes those applications involving acquisition debt and has denied a number where such debt would create undue pressure for increased dividends from bank subsidiaries, especially when the bank needs, or is likely to need, capital. We expect the parent company to be a source of strength to its subsidiaries and not a drain on their resources.

Approval of nonbank acquisitions has similarly been given following a determination that competitive benefits are likely to flow from the acquisition and that some significant public benefits will develop such as greater efficiency, lower interest rates, or broader services. We have designed our procedures to promote *de novo* entry by making the application and review process easier and quicker. Moreover, the Federal Reserve has shown a distinct preference for having bank holding companies acquire small or intermediate-size firms rather than the largest companies. We, of course, have moved carefully in reaching decisions as to which industries are closely related to banking and where operation by a holding company would be of public benefit. Under Regulation Y, the Board so far has determined twelve categories of nonbank activities to be permissible for bank holding companies, and has ruled that eight types of activities are not permissible.

Beyond these rather specific requirements, the Board has adopted policies concerning bank holding company expansion which over the past two years has significantly slowed this expansion. The Board adopted this "go-slow" policy because it believed that managerial and financial resources could often be used more effectively to strengthen existing operations, particularly in the bank subsidiaries, some of which had experienced sharply declining capital ratios or large loan losses.

Similarly, we have increased our efforts to improve the supervision of bank holding company activities by more intensive monitoring of bank holding company financial affairs and intra-company transactions. From revised and expanded financial reports, we will acquire much more information on bank holding company activity. Also a quarterly report on intra-company transactions will permit the Federal Reserve to monitor closely any unusual transactions or transfers between holding company affiliates. The Federal Reserve has increased its inspection program for bank holding companies and nonbank subsidiaries so that developing financial problems may be identified as early as possible. Such inspections also allow a check on compliance with the Bank Holding Company Act and with Federal Reserve regulations created to implement that Act. We have increased our contacts with the managements of bank holding companies so that we may be better informed about the condition of their companies and where problems may develop. Moreover, we have been increasing our use of agreements or cease and desist orders to bring about the correction of specific problems.

After five years of experience in enforcing and regulating the 1970 Amendments to the Bank Holding Company Act, the Federal Reserve has found it desirable to suggest to Congress certain changes in that Act which would improve our ability to correct problems or deter their development. Specifically, the Board has requested Congress to give it the authority to invoke civil penalties for violations of the Bank Holding Company Act and thus deter the violations which are being discovered in our holding company inspections. Also, the Board has asked for authority to order divestiture of nonbank subsidiaries or nonbank activities where they are endangering the bank subsidiaries of a holding company.

As a method of dealing with situations where a bank is in serious financial difficulty, we have requested modification of the Act to permit waiver of the 30-day waiting period before an acquisition can be consummated. This authority parallels that in the Bank Merger Act. Similarly, we have requested a change in the statute that would permit inter-state bank holding company acquisitions where a bank or holding company in difficulty is so large that it cannot be acquired by any in-state companies without creating competitive problems.

I would now like to state the Board's specific response to the FINE Discussion Principles as reflected in Title III. The first elaborates on a prior principle that a Federal Depository Insitutions Commission be created and that it have authority for supervision, regulation, and examination of bank and savings and loan holding companies. As reflected in our prior testimony, the Board is opposed to the creation of this depository institutions commission, and, hence, opposes the provision that the powers of the commission cover bank holding company activities.

The second Discussion Principle in this title would subject holding companies to the jurisdiction of the Federal Depository Institutions Commission so as to promote healthy competition among depository institutions, and to prevent the acquisition of banks or savings and loan associations that would tend to lessen competition in a financial market. The Board strongly endorses and has worked toward promoting healthy competition among depository institutions. In its administration of the Bank Holding Company Act, the Board has repeatedly denied proposed acquisitions of banks and nonbank companies that would result in anti-competitive effects. Only in those rare cases, such as with the acquisition of a failing bank, where demonstrable public benefits would outweigh relatively slight anti-competitive effects, has the Board approved acquisitions of this character. I can assure you that the Board pays extremely careful attention to the competitive effects of every proposed acquisition.

The third Discussion Principle calls for prohibiting the holding company and subsidiaries from using names in such a way so as to cause public confusion. We perceive the purpose of this provision as an effort to disassociate depository institutions from the rest of the holding company system in the public's mind so that financial trouble elsewhere in the System would not have an impact on the depository institutions in such a way as to cause a loss of confidence. The Board believes that such a prohibition would give the depository subsidiaries of bank holding companies a modest degree of protection, but does not believe such protection would be complete or very effective. The sophisticated holders of liabilities of depository institutions are aware of the organizational links to the rest of the holding company system whether the name is identical or even similar. Such investors or depositors can be responsible for wide swings in deposits of individual institutions during periods of financial stress. In recent experience, typically it has been the large uninsured depositor or creditor who has sought protection by withdrawing his funds from depository institutions.

In a practical sense, also, even if the names are not similar, the holding company may still feel responsible for the non-depository unit in the holding company and thus may attempt to use its depository affiliates to come to the aid of that nonbanking unit in times of adversity--subject, of course, to the limitations in Section 23A of the Federal Reserve Act. There would be some cost in forcing all holding companies to change the names of their nonbanking affiliates including the denial to holding companies of one of the benefits of the holding company form which is the strength of the holding company name on the nonbanking and bank subsidiaries. Furthermore, the proposal runs counter to the view that the public has a right to know with whom it is doing business. Also, there may be legal implications of forcing such a name change between the parent and its non-depository subsidiaries, which Congress should review carefully before adopting this principle.

The next proposal concerning holding companies is another attempt to avoid public confusion by requiring that any liabilities issued by non-depository subsidiaries clearly state that the liabilities carry no guarantee by any depository institution in the holding company system, or by the U.S. Government. The Board believes that this proposal is desirable since it would tend to clear up any confusion or misunderstanding that might exist. While lending its support to this proposal, the Board nevertheless believes that there should be recognition of the practical position of many bank holding companies that the debt of any subsidiary ordinarily should not be allowed to go into default for fear of injuring public confidence in the holding company as a whole or in its bank affiliates. In addition, some support of the liabilities of nonbank affiliates may be desirable in the normal course of business, as in the case where a bank issues a "partial" standby letter of credit, subject to Section 23A, to facilitate marketing of the debt of an affiliate.

Another Discussion Principle requires the Federal Depository Institutions Commission to determine before permitting any action by a depository institution with a holding company, a subsidiary, or an affiliated nonfinancial institution, that such action would not weaken the depository institution in question. The Board assumes that it is the intent of this provision to prevent intra-holding company transactions that would adversely affect depository subsidiaries. The Board wishes to point out that such a proposal, though tending to prevent such adverse actions, would involve substantial administrative costs to review each and every transaction. In addition, prior approval of each transaction constitutes an unwarranted interference in the management of the company.

As far as banks are concerned, existing laws such as Section 23A of the Federal Reserve Act already give bank affiliates of the holding company some protection from abuse. However, as already noted in this testimony, there have been intra-holding company transactions which have created problems for bank affiliates. In that regard, the Board has taken several steps to reduce or counter the adverse effects of such transactions. First, the Board has recently stepped up its monitoring program dealing with bank holding company financial developments. Second, as noted above, the Board has begun an intra-company transaction report and also requires almost immediate notice of transactions involving large amounts or a large proportion of a holding company's income or assets. Third, in order to prevent bank affiliates from being harmed by unsound financial practices of the holding company or its nonbank subsidiaries, the Board has requested and received authority from Congress to bring cease-and-desist actions, if necessary, against holding company units. Fourth, the Board has acted to limit certain transactions by banks with affiliates.

The Board has interpreted limitations placed on member bank loans to affiliates, under Section 23A of the Federal Reserve Act, to include assets purchased from these affiliates. In addition, the Board has amended Regulation H to require member banks to treat standby letters of credit and ineligible acceptances as loans for purposes of determining limitations on loans to affiliates.

The Board believes that if existing laws and procedures are not sufficient to reasonably protect the bank subsidiaries, it would be preferable to tighten the laws on intra-company transactions rather than to prohibit such transactions except with prior approval by regulatory authorities. Currently the regulatory agencies are studying possible recommendations for strengthening of Section 23A of the Federal Reserve Act.

Turning to the next Discussion Principle, the Board supports the proposals to remove present limitations on the amount of loans between affiliated depository institutions and to abolish the requirement that such loans be secured. We believe that within broad limits, it is reasonable to allow a statewide holding company system to transfer funds among its depository affiliates just as a statewide branch banking system can transfer funds among its branches. Such a provision would be particularly desirable in facilitating federal funds transactions among depository affiliates of the holding company. It is believed that the restrictions presently placed on such intra-company depository loans were among the principal reasons for the conversion of a large number of holding company affiliates into statewide branching networks when the New York State law was recently changed to permit statewide branching.

The next of the Discussion Principles would prohibit transactions other than routine deposit transactions between a depository institution which is a subsidiary of the holding company, and any investment company including real estate investment trusts, which it manages or advises. We question whether it is necessary to prohibit all transactions between depository institutions and an investment company both related to a single holding company. For the depository institution, the amount of loans to a REIT advised by a holding company unit would be limited by existing law, usually to 10 percent of the bank's capital. Nevertheless, we do recognize that such loans could be made by a number of separate units and perhaps in the aggregate might constitute an overconcentration of credit for the company as a whole.

The Board is mindful that the purchase of assets by a bank from a real estate investment trust advised by the holding company is not presently limited by law except to the extent such a purchase constitutes an "unsound" banking practice. Nevertheless, we are watching such transactions of state member banks very closely and would not hesitate to take decisive action if a transaction constituted an unsound banking practice.

In order to promote disclosure, the next Discussion Principle would require the Federal Depository Institutions Commission to obtain and make publicly available by market area on a periodic basis, information concerning loans and other financial transactions between depository institutions and the rest of the holding company system, as well as institutions such as real estate investment trusts advised by the holding company system. The question of the degree or type of disclosure of holding company financial affairs is one which is currently under considerable study both by the regulatory agencies and the Securities and Exchange Commission. The Board recognizes that to achieve market discipline of holding companies there will have to be additional disclosure of their financial condition, and it has participated in extensive discussions with the Securities and Exchange Commission about which data should be developed and how they are to be presented

The final provision in Title III of the Discussion Principles applies to the composition of the Board of Directors of each depository institution and holding company as well as the important committees of each institution. The provision requires that one-third of the members of the Board of Directors and all the important committees be independent. That is, they should have no affiliation with the holding company or any of its nondepository affiliates. It appears to us that the purpose of this provision is to give the depository institutions greater protection from any possible abuse by the rest of the holding company system. We believe that independent directors would be of some help. But it is doubtful that the proposal would offer depository institutions a significant amount of protection. The proposal would still leave independent directors in a minority position. Moreover, directors are obligated to defend the interest of the stockholders, and the stockholder of a depository affiliate is the holding company which would or could be the source of the abuse.

If this FINE proposal were to be adopted, however, we would urge that small holding companies be exempted. We suggest this because in smaller towns and for small companies elsewhere, the available supply of qualified directors is often limited.

In conclusion, the Board believes the Banking Committee is rendering an important service in leading a discussion of what may be the useful and feasible elements of financial institution reform. Our net assessment of the bank holding company movement is presently favorable, but it is clearly too soon to render definitive judgments on all aspects of the movement. We hope our review of the development of bank holding companies, and our comments on the FINE Discussion Principles applicable to them, will be helpful to the Committee.

Thank you.

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