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TEN C's OF HOLDING COMPANY REGULATION

Remarks of

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Ten C's of Holding Company Regulation

Reviewing bank holding company regulation by the Federal Reserve, one can scarcely avoid the impression that in many ways bank holding company regulatory matters are a microcosm of financial concerns for the entire nation. In an attempt to bring the primary policy concerns into focus, I have grouped them into 10 sections and propose to comment on each, giving some flavor for Federal Reserve policy and some pattern of decision-making. As always, I speak only for myself, not my associates or the Federal Reserve.

Convenience and Needs

As might be expected, the Federal Reserve looks for the public interest in all applications presented. In most, the public benefits of increased competition, greater services, lower prices, improved efficiency, or salvage of an uneconomic or failing institution may be present to one degree or another. When these are sufficient to provide a positive tilt to the acquisition or offset minor competitive problems, the Board usually approves them.

In a substantial majority of cases, the Federal Reserve finds that proposed acquisitions will likely result in at least some public benefits. However, convenience and needs considerations are seldom judged to be so weighty as to overcome major adverse findings regarding competition and financial and managerial considerations.

The public interest test is often a matter of great concern to the Board because it finds cases where the primary benefit is a tax shelter. Most often, in one-bank holding company formations, the only reason for the formation is a tax advantage to the owners of the bank. Since the Board is not the tax-writing authority of this nation, it must take the laws as given, even though I view some organizational applications as sheer tax-inspired efforts.

Similarly, the Board has viewed as inequitable the treatment of minority shareholders in some bank holding company policies and procedures.^{1/} However, the Board is refraining from using an action on a BHC application as a means of remedying all the real or potential problems in the financial world. After all, a court has ruled that the Board could not deny applications on the grounds that there was not an equal offer to all stockholders.^{2/} The conditions for approval in individual cases usually involve the specifics of matters tied to safety and soundness of the bank or BHC rather than a broad philosophical limitation based on morality or equity. As I vote on the various applications, I am tempted to urge that we condition our approval by broad restrictions to insure a high moral tone in this public service industry, but I am dissuaded by the lack of legal authority, the need to make ethical judgments in fields where reasonable men can differ and the problem of enforcing those judgments in an equitable fashion.

^{1/} Order denying applications by Western Bancshares, Inc. to retain Rooks County State Bank and Woodston Agency, August 31, 1972.

^{2/} Western Bancshares, Inc. v. Board of Governors (480 F2d. 749).

Competition

When BHCs apply to the Federal Reserve to make acquisitions under Sections 3 and 4, the Federal Reserve must investigate the competitive implications of the proposal by determination of the relevant market, the presence or absence of the applicant in the market and its relative size. If the proposal involves a horizontal acquisition, we assess the degree of the adverse impact on competition: first, by reference to the resulting change in market structure--the number of banking organizations in the market and the market shares of the acquiring firm and the firm to be acquired; second, by a review of overlapping deposit or loan patterns between the parties in the proposed acquisition; and, thirdly, by analysis of the potential loss of a means of market entry for another BHC. If the firms are in different markets, the Federal Reserve assesses the impact of the proposed acquisition on probable future competition as well. Key elements in this analysis are the market share of the firm to be acquired; whether the acquiring organization is a likely future de novo entrant into the market if the proposed acquisition were denied (this depends on the attractiveness of the market among other factors); whether there are a significant number of other potential entrants; and, whether the market is already highly concentrated.

The Board has traditionally taken a rather "hard" stand on competitive issues. The position is based on the view that bank market structure importantly affects bank conduct, which in turn affects market performance.

Competitive analyses often trouble the Board. We have had many discussions on the definition of a banking market, the question of recognition of sub-markets in a large banking market, and the forecasting basis for potential competition. We are occasionally faced with competitive issues involving a bank which was not servicing its community or a concentrated market of near equals without BHC ownership.

It is interesting to note that over the last decade a substantial portion of SMSAs and county banking markets have apparently become more competitive, as evidenced by an increase in the number of banking organizations competing in the market and a decline in market concentration.

Compromise of Small Banks

For many years there has been concern over the impact of the BHC movement on small banks. This concern is held not only by small bankers themselves, but by many individuals and organizations that consider a concentration of economic and political power a threat to our democratic processes. Available evidence, however, indicates that small banks are apparently surviving the BHC movement quite well:

Recent studies indicate that the internal growth of small banks has been faster than that of the banking system. Empirical evidence also indicates that when BHCs enter a market through acquisition, they normally have not made major inroads on the market shares of banks already in the market. This suggests that small banks have stood up quite well under the pressure of BHC entry into their market.

In some small banking markets or sub-markets within large areas, there may be difficult problems for small banks, especially newly-formed ones. While the Board has clearly rejected a "protected-market" theory, some of us are concerned that BHC de novo banks indiscriminately placed, may create hardships for newly-developing independent banks or banks in markets which are not yet sufficiently grown to support multi-unit competition.^{1/}

Concentration

In processing BHC applications, the Fed also gives consideration to the impact of an acquisition on the concentration of resources. However, because most BHC applications have involved relatively small or intermediate-sized firms, the concentration issue has not been a major factor in most cases to date. In several cases,

^{1/} Order denying application by First of Orlando Corporation (now Sun Banks of Florida, Inc.) to acquire Citrus First National Bank of Leesburg, March 6, 1973.

however, the Board did give significant weight to the concentration issue in reaching a denial decision^{1/} and I have given even greater weight to it in a recent dissenting opinion.^{2/}

With regard to concern over aggregate concentration in banking, it should be noted that the percent of total domestic deposits held by the 100 largest banking organizations is now almost exactly the same as it was two decades ago, even though these 100 organizations have made a significant number of acquisitions through the holding company device.

At some state and local levels, however, there have been marked increases in concentration. For example, the top five banking organizations in Colorado have increased their percent of state-wide deposits from 47.2% in 1970 to 55.8% in 1975. The Board registered its concern about certain developing concentration patterns, and has kept a close eye on others. Limits on horizontal acquisitions by dominant banks have been evident in some Board denials.^{3/} Of course, the existing high degree of concentration in some states is beyond control, but in other states, the BHC development is being monitored carefully to resist excessive concentration.

^{1/} Order granting request by BankAmerica Corporation for reconsideration and approving acquisition of GAC Finance, Inc., August 14, 1973; order denying application by First National City Corporation (now Citicorp) to retain Advance Mortgage Corporation, December 26, 1973; and order denying application by Chase Manhattan Corporation to acquire Dial Financial Corporation, January 30, 1974.

^{2/} Order approving application by First National Bancorporation to acquire First National Bank of Montrose, September 30, 1976.

^{3/} Order denying application by Southeast Banking Corporation to acquire the First National Bank of Homestead, March 22, 1974; order denying application by First City Bancorporation to acquire Meyerland Bank, June 26, 1974; and order denying application of United Banks of Colorado to acquire The First National Bank in Golden, June 13, 1975.

Conflicts of Ownership and Control

In some instances, BHCs control a bank, but do not have 100 percent ownership. In such cases, a BHC could take certain actions that would benefit the BHC at the expense of minority shareholders. For example--the BHC has the bank pay management fees to the parent company that significantly exceed the value of any services that the parent company may have performed. Such an action not only has an adverse effect on the bank's financial position, but also adversely impacts minority shareholders of the bank, who presumably have no ownership interest in the parent. In principle, the Federal Reserve opposes BHC actions that are obviously unfair to minority shareholders. However, it should be recognized that minority shareholders have access to the courts in cases of abuse.

The Board has also been faced with problems of control by BHCs. Especially in foreign joint ventures but also in some non-bank acquisitions, control becomes an important element triggering certain responsibilities and liabilities for the BHC and therefore elements for consideration by the Federal Reserve. Legal control factors are not the only control problems for the Federal Reserve in regulating BHCs. Control is the dominant factor when a BHC seeks to solve a problem in one subsidiary by asset transfers, excessive dividend payouts or management fees, or large debt issues to achieve funds to meet losses.

In some cases BHCs have sought to protect their own minority ownership positions by credit extensions which with further adverse conditions leave the BHCs exposed to significant loss. Such circumstances usually bring an emergency request for approval for additional share ownership. In a few such cases of BHC minority ownership, inadequate legal advice may have led a bank holding company to buy more stock without Board approval, which is a violation of the BHC Act.

Concerns of Classified Assets, Capital Adequacy and Management

In the last several years the problem assets of BHCs have risen significantly, and during the early 1970s the capital ratios of BHCs declined at an unusually rapid rate. Moreover, the movement of some BHCs into new banking markets abroad and the movement into a variety of nonbanking activities in some cases probably stretched BHC management a little thin.

In reaction to developing financial problems, the Board in mid-1974 implemented its "go slow" policy.^{1/} The objective was to encourage BHCs to give primary attention to improving their financial condition, and to devote the bulk of their managerial attention and financial resources to their banking operations.

^{1/} Order denying application of BankAmerica Corporation to acquire Allstate International S.A., ~~1974~~ 19, 1974; and, order denying First Chicago International Finance Corporation to acquire Banco Popular Espanol U.K. and United Chinese Bank, June 27, 1974.



In recent months, there has been evidence of significant progress in some areas. Perhaps most striking has been the relatively sharp improvement of BHC capital ratios.

Despite the rather extensive publicity to the "go slow" policy, some large BHCs which suffered from financial strains, continued to apply for new acquisitions risking the possibility of denial. Unfortunately, some of the BHCs structured their acquisition agreements in such a way as to limit their flexibility to respond to adverse comments before Board consideration.

To avoid misunderstanding about the "go slow" policy, I will state my position on the matter. For BHCs under severe financial strain with banks that have significant asset or earnings problems, I would counsel no expansionary applications which imply further drains upon financial strength or management. As the BHCs work out from under their classified asset positions, I would favor resumption of slow expansion into areas of bank expertise.

Compliance with Prior Agreements, Conditions of Acquisition
and Divestiture

In making applications to the Federal Reserve, BHCs frequently pledge to bring about certain public benefits or financial improvements, if allowed to make the acquisition. These pledges take many forms and often include increased services, lower prices, an infusion of capital or improved management. In reviewing these

applications, the Federal Reserve gives these pledges some weight. Subsequent to any approval of these applications, the Federal Reserve obviously expects these pledges to be honored.

Similarly, in approving some applications, the Federal Reserve attaches conditions to the approval. Without these conditions, the Federal Reserve in some instances would have denied the application. Since these conditions are an integral part of the approval, the Federal Reserve expects the conditions to be adhered to, except in those rare cases where the Federal Reserve subsequently acknowledges that events have made adherence impractical or unnecessary.

In some recent cases, we have reduced the exposure from the expansion of nonbank activities by limits on leveraging ratios. In other cases, we have limited the number of de novo openings. Similarly, for some bank acquisitions we have conditioned our approvals by requiring debt structuring so that capital ratios will not deteriorate over the maturity period. All of these efforts have been aimed at protecting the primary bank or its holding company from undue expansion or unsustainable debt burdens.

In some Section 4(c)(8) applications, a BHC proposes to acquire a company that, to some limited extent, is engaged in impermissible activities. In this event, the BHC is required to divest these impermissible activities within a specified period after

acquisition. Again, in approving such proposed acquisitions, the Federal Reserve expects BHCs to meet these deadlines. In fact, the law does not permit the Federal Reserve to extend some divestiture time limits. In a longer-run context, there are several BHCs who have irrevocably committed themselves to divesting their banks. We hope that those companies are watching the years roll by because we expect such divestitures to be completed by the statutory time limit of 1981.

Capacity to Handle and Control Impact of Nonbank Activities

There is reason to believe that BHCs should have the capacity to handle activities that have been made permissible under Section 4(c)(8) since 1970:

1) Most of the activities are ones in which BHCs could already engage in through their banks, and in some cases were already doing so.

2) All permissible activities, by the requirements of the statute, must be closely related to banking, and, therefore, should not take bankers very far away from their traditional areas of expertise.

In 1974 and 1975, however, some BHCs encountered significant financial problems in the nonbank area. The major problem area was mortgage banking. The BHCs' poor profit performance in mortgage banking was undoubtedly largely due to severely depressed conditions

in real estate markets. But in some cases, poor performance was also due to overly aggressive lending and lack of due diligence in monitoring the asset expansion or the developments in the market.

In addition, some BHCs and banks in consortiums failed to check on the condition of the credit, leaving to the lead bank the appraisal and continued analysis of the loan and its collateral. Poor communications between the lead bank and others in the consortium led to misunderstandings and some outright withdrawals.

In a broader sense, the Federal Reserve has had a problem of protecting banks which were subsidiaries of BHCs with nonbank problems. Both the nonbank subsidiary and its holding company have been sources of problems to individual banks.

Partly in response to problems like Beverly Hills and Hamilton, the Federal Reserve has been giving increasing attention to controlling the impact on BHC banks of financial problems originating with BHC nonbank affiliates or the parent company. To achieve an early perspective, we are closely monitoring the financial affairs of nonbank affiliates and the parent company in order to head off major problems before they develop. This monitoring is done both through an analysis of various BHC financial reports and through on-site inspections by the Federal Reserve Banks.

Through quarterly reports filed by larger BHCs, we are closely monitoring transactions between BHC banks and the rest of the BHC organization. The basic objective here is to protect the banks from abuse, such as the dumping of bad assets into the bank by a troubled nonbank affiliate. Even with these efforts, however, it is probably not possible to entirely protect BHC banks from trouble originating elsewhere in the BHC system. In part, this is due to the strong public identification of the bank with its holding company.

We have weighed the regulation of bank holding company organizations against their potential efficiencies and competitive advantages. One school of thought leans toward regulatory isolation of the bank while another treats the whole organization as if it were a bank. Frankly, I believe we are on a path of:

1. Strengthening the regulatory control of banks;
2. Erecting a few but important barriers to bank impact from nonbank problems within the organization; and,
3. Providing a minimum of bank-type regulation on the nonbank elements.

Whether this course of policy can continue permitting generally free competition in the nonbank elements will be a major question if more BHCs run into problems which are then transmitted from the nonbank to the parent and on to the bank subsidiary.

Contribution of MBHCs

The Federal Reserve is constantly monitoring and doing research on various aspects of the BHC movement. On the basis of this assessment, we believe the following have been the major contributions of BHCs:

First, increased competition is evident from de novo entry into new markets in both banking and nonbanking activities and from BHC acquisition of "sleepy" banks and turning them into more effective competitors.

Second, we are seeing increased convenience and an expanded range of banking services (e.g., offering a wide variety of financial services through certain consumer finance offices).

Third, in some cases there has been considerable improvement in the financial and managerial resources of bank and nonbank companies that were acquired.

A number of studies have investigated the impact of BHC acquisitions on efficiency in banking. All of these studies have encountered major methodological problems, and the findings of the studies have been mixed.

On the other hand, the MBHCs may have contributed to some of the financial problems. This statement rests on clear evidence of abuse of banks by some bank holding companies, some instability in financial markets, and some increased impact of major retrenchment decisions. How much of these problems are properly laid on the doorstep of the malaise of very tight credit conditions, the subsequent economic recession, and the large losses created by the aforementioned is difficult to say. Perhaps greater experience with the BHC movement will clarify the degree to which this form of organization is or is not contributing to the overall public interest.

Congressional Limitations

In regulating and supervising BHCs, the Federal Reserve obviously must follow the provisions of the statute as written by the Congress. There have been a few occasions where the Federal Reserve would have liked to take a certain action--believing that it would be in the public interest--but could not do so because of the constraints of the statute.

On a few occasions, the Federal Reserve has believed that existing legislation impeded its effective regulation of BHCs. In these cases, the Board has forwarded legislative recommendations to the Congress. Recent examples are draft legislation that would allow the Board: (1) to approve promptly an acquisition or merger

under Section 3 when the bank or BHC to be acquired is in severe financial difficulty; and, (2) to approve the acquisition by an out-of-state BHC of a troubled bank in certain emergency and failing bank situations.

In exercising its regulatory powers under the BHC Act, the Federal Reserve must necessarily take into account the current concerns of the Congress. Normally, these Congressional concerns are also the current concerns of the Board. Recent examples of mutual concerns are (1) problem banks, and, (2) the relationship between BHC banks and the rest of the BHC system. In the former area, the Federal Reserve has exerted its supervisory authority to constrain excessive risk-taking and to build up capital ratios. In the latter area (as previously discussed), the Federal Reserve has established an extensive surveillance system to monitor transactions between BHC banks and the rest of the BHC system, as well as REITs advised by the BHC.

In summary, I have attempted to give you a flavor of the primary concerns of the Federal Reserve in its regulation of bank holding companies. I view the approach as a dynamic one responding to the problems of the day but with consistent themes of (1) increased service in meeting of the convenience and needs of the public, (2) greater competition for the financial business in each banking market, and, (3) monitoring, control, and regulation against excessive concentration of credit power, abuse of banking institutions, and

unsafe or unsound banking practices. Your attention and help in keeping these ten C's of bank holding company regulation in mind as you seek to serve your communities and customers at a profit to yourselves will enable us to move forward in a balanced fashion.

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