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BANK HOLDING COMPANIES AND FINANCIAL STABILITY

Paper presented by

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The financial experiences of the last two years impel a careful and wide-ranging review of the stability of our major types of financial institutions. That review ought to be followed by actions to redress weaknesses or proclivities that, upon analysis, are judged to contribute an undesirable degree of instability within the financial system.

I can report that we in the central bank are deeply involved in such a review. A number of our colleagues in Government, both here and abroad, are similarly engaged. I know many bank managements who are devoting a great deal of time to thinking through the implications of these events for their own institutions.

I devoutly hope that the fraternity of academic economists will also be a major contributor to the stream of reappraisals of financial stability. Your comparative advantage, of course, is your capacity for greater

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I want to particularly acknowledge the assistance of Stephen A. Rhoades, Economist in the Board's Division of Research and Statistics, in the preparation of this paper. Except where explicitly indicated otherwise, the positions herein expressed are my personal views and should not be construed as official positions of the Board of Governors of the Federal Reserve System.

objectivity and abstraction than we practitioners can claim. If you can exploit that comparative advantage effectively in this sensitive area, I and many people like me will be very much in your debt.

From my more parochial vantage point, I would like to focus attention this afternoon on the contributions to financial stability, or instability, that I perceive in the bank holding company movement. That movement has waxed powerful enough in recent years to make it one of the central elements in our financial system. By December 31, 1970, bank holding companies controlled 2,241 commercial banks with deposits of $253 billion -- 52.6 per cent of all U.S. commercial bank deposits. By the end of 1974, bank holding companies controlled 3,462 commercial banks with $509 billion in deposits, accounting for 68.1 per cent of commercial bank deposits. Acquisitions of going concerns which have long been regarded as a major vehicle for growth in the theory of the firm, have increased substantially. In 1970, bank holding companies accounted for slightly less than 50 per cent of all acquisitions of banks, whether by purchase by a bank holding company or merger into another bank. By 1973, this figure rose to over 73 per cent.

Expansion of bank holding companies into nonbank activities in recent years has also been impressive. The number of acquisitions of nonbank firms by bank holding companies rose from six during 1970 to 827 and 806 in 1973 and 1974 respectively. De novo entry into nonbank activities has also been substantial, with the number of such entries rising from 71 during 1971 to 542 during 1974. An important contributor to these large acquisition numbers is the practice by many finance companies and other subsidiaries of separately incorporating offices in different legal jurisdictions. When such clusters of "office corporations" are netted out, however, the overall data still show the existence of 531 bank holding companies controlling 3,632 nonbank companies as of December 1970 and 721 bank holding companies with 4,812 nonbank companies by December 1973.

II.

These bank holding company dimensions raise two particular questions of stability in my mind. The first concerns the possibility of an undesirable interruption in the availability of financial services, such as can happen during periods of tight money.

Most such interruptions at individual firms are primarily the product of overaggressive management -- management making decisions which exceed the firm's capacity to produce what is promised. While instances of overaggressive management have appeared in banking in recent years, it is worth pointing out that such behavior is not a necessary result of the bank holding company form of organization. The bank holding company is simply a convenient channel through which aggressive management behavior can express itself. As a general proposition, the bank holding company format can be held responsible for no more than inviting some over-aggressive management behavior in banking because of the added scope for maneuver which it afforded.

Virtually all banks engaged in active financing of a substantial part of the nation's economic activity showed some deterioration in conventional "soundness" measures during the last few years, whether or not they were in a bank holding company. The equity-asset ratio for large holding company banks, however, appears to be lower on average than that for large independent banks. A multi-variate analysis by Board staff members has found evidence that among the 500 largest commercial banks (1) bank holding company banks tend to have a significantly lower capital-assets ratio than independent banks, and also (2) the capital positions of banks acquired by bank holding companies tend to decline relatively subsequent to their affiliation.[1/] For whatever reasons, bank holding companies appear inclined to increase the leverage of their bank subsidiaries.

1/ Heggestad, Arnold A. and Mingo, John J., "Capital Management by Holding Company Banks," Journal of Business, forthcoming. Incidentally, differences in bank size were accounted for in this study, and the data indicated that the above-cited differences are not simply due to bank size.

A more selective way to judge the contribution of bank holding companies to financial stability is to look at the character of their acquisitions. The information that I can report on this score is more qualitative and judgmental, and is confined to domestic affiliations, but I believe it is nonetheless useful.

Turning first to banks that have been acquired by multi-bank holding companies, there have been a small number of seriously weak banks in various parts of the country that have been absorbed by bank holding companies in recent years. In every case I know, the weak bank was subsequently strengthened -- at least a little -- and such improvement is a clear and positive contribution to financial stability. The number of such rescues to the credit of bank holding companies would be larger, I believe, if appropriate legislation were adopted to liberalize some current statutory constraints on such efforts.[2/]

2/ The Board of Governors has recently proposed specific legislation to further this objective (S. 890 and H.R. 4008). One proposed provision would waive the present statutory 30-day delay between Board approval of a holding company acquisition and its consummation by the applicant; the second provision would allow a bank holding company to acquire a large failing bank in another state, if no desirable alternative buyer could be found.

More typically, however, banks acquired by bank holding companies had prior records of relatively conservative management, and their post-acquisition reports are more likely than not to show increased loans to their communities. Judged narrowly, such a change has to be scored as an increase in the potential instability of the particular subsidiary bank. A case can often be made, however, that the earlier management had been overly conservative, and that the holding company, because of its greater size and geographic diversification, is better equipped to handle higher loan ratios.

With respect to acquisitions of nonbank firms by bank holding companies, a rather different story emerges. Generally, the nonbank firms acquired by bank holding companies in recent years have been smaller and weaker financially than the acquiring organization.3/

3/ At least partly, this may be a result of the demonstrated disinclination of the Board to allow the largest bank holding companies to acquire the largest firms in any bank-related industry.

Thus, in the first instance, affiliation with the more powerful organization strengthens the position of the nonbank firm. Oftentimes such strengthening is manifest in such concrete ways as reduced interest rates on sales of its debt obligations or loans from outside institutions. Improved access to funds by the new affiliate also has the potential for financing subsequent more rapid growth and less fluctuating volume relative to the affiliate's past performance or to the record of independent competitors in its industry.

These changes are of sizable import for the financial system, since in several key nonbank financial lines the percentage of the industry's total receivables held in bank holding company organizations has become substantial. The table below presents estimates of how far that penetration has proceeded in the consumer and sales finance industry, mortgage banking, factoring, and lease financing.

These are all lines of activity in which many independent firms have experienced sharp cyclical ups and downs in their ability to finance customer demands. At least for such firms, the protective wing of a parent bank holding company has usually brought a greater measure of financial stability.

Table 2

Estimated Shares of Industry Receivables
Held by Bank Holding Companies
December 1974

Industry	Share Held by Bank Holding Companies and Nonbank Subsidiaries
Consumer and Sales Finance (86 largest noncaptives)	22%
Consumer and Sales Finance (105 largest, including captives)	9%
Mortgage Banking (100 largest measured by volume serviced)	32%
Factoring (30 largest)	50%
Leasing (estimate)	10%

Source: Board of Governors of the Federal Reserve System

On the other hand, it is impossible to avoid the logical conclusion that absorbing these weaker nonbank affiliates has placed a greater burden on the resources of the parent holding company, and also on its lead bank or banks. This is all the more true because reports to date suggest that bank holding companies may tend to leverage their nonbank affiliates more than the independent competitors of such affiliates. Such greater leveraging underlines the reliance upon the strength of the parent company and lead subsidiary bank(s) to achieve and maintain adequate market acceptance.

Presumably it is an acceptable assertion that banks on average are less risky enterprises than their nonbank affiliates. Nonetheless, since the latest wave of nonbank acquisitions began around 1969, I know of only a handful of cases in which nonbank affiliates' performance was so poor as to seriously destabilize the parent holding company or its lead bank. The problems of a few affiliate mortgage companies and bank- and bank holding company-sponsored real estate investment trusts fall into this category.

In the most extreme case, that of the Beverly Hills Bancorp, analogous difficulties were instrumental in bringing down the bank, but in other cases to date the damage has been more limited.

The passage of more time, of course, could bring more problems to the surface. On the other hand, the past year was surely a time of unusual financial stress. Managements have generally become more conservative, and so have creditors of bank holding companies. Future years may be less turbulent and provide opportunity for more settled operations with less depressed net earnings.

In trying to judge the degree of instability injected by nonbank affiliates, it is important to keep in mind what a small share of total bank holding company assets they presently represent. At last report (1973), balance sheet assets of nonbank affiliates accounted for only 3 per cent of the total assets of 69 of the largest bank holding companies. Extra risks of those dimensions are not likely to constitute a threat of any major consequence to the banking system as a whole, even though the viability of an individual organization might be prejudiced.

While such industry dimensions are still relatively modest, however, there are certain areas of doubt or uncertainty which might well be clarified in the interest of promoting financial stability. One involves possible differences of view as to the extent to which bank and bank holding company resources will in fact be drawn upon to pay the liabilities of any nonbank affiliate. The fact is that current law and regulation limit the ways in which bank resources can be tapped to meet problems that afflict affiliates. Business considerations, however, typically impel a bank holding company management to do whatever it responsibly can to honor the obligations of its affiliates.

Occasionally, among the interested groups dealing with a bank affiliate -- its creditors, its customers, and its parent's shareholders, directors, depositors and regulators -- representatives of one group will voice a stronger or weaker expectation than another as to parent and lead bank support for the nonbank affiliate in time of need. It will be important for the future of the industry for such views to be homogenized. Both holding company managements and their regulators need to work assiduously at this task.

A second area in which clarification would be timely deals with "double leveraging." This phenomenon can take place in a variety of ways, but is thought of most simply as a bank holding company borrowing money and investing it in equity securities in its key bank affiliates.

Within judicious limits, this kind of financing can have significant tax advantages for the holding company. That double leveraging is often practiced is indicated by the fact that the 25 largest bank holding companies combined invested $417 million in new equity of their subsidiary banks in 1972 and $371 million in 1973.[4/] These equity investments in subsidiary

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4/ Acquisitions of banks and acquisitions of existing shares in partially-owned banks are excluded.

banks substantially exceeded the net new equity issued by the parent bank holding companies. Parent company issues totalled $140 million and $116 million in 1972 and 1973 respectively.[5/]

That double leveraging has thus far been judiciously practiced is suggested by the fact that, for the 25 largest bank holding companies as of 1973, the total of their equity investments in all bank and nonbank affiliates was only 8 per cent larger than the recorded shareholders' equity in their parent holding companies. Reassuring though this experience may appear to date, market questions as to what might be safe limits for "double leveraging" suggest the wisdom of developing a realistic consensus on this point as well, underscored by supervisory or regulatory action if need be.

5/ Only $58 million of that $256 million of parent company equity issues in 1972-73 was raised by sales in the public market; the other $198 million of equity was obtained through conversion of existing debt and stock option plans. Shares issued in acquisitions are excluded from these figures.

III.

Thus far in my remarks I have concentrated on considerations of financial stability in the most conventional sense of that term. In this section of the paper I should like to turn to a second and less desirable dimension of financial stability -- namely, the local market stability that can result from a less than vigorously competitive group of sellers of financial services.

That kind of market stability, with sticky prices, little service innovation, and tacitly uncontested market shares, epitomizes much of what economists count on competition to dispel. In general, it is regarded as in the public interest to dispel any pockets of such excessive market stability. A powerful force for dispelling such pockets of stability has been created by the recent rapid spread of bank holding company organizations into new services and new geographic markets. Time after time, the intrusion of an out-of-town bank holding company affiliate into an existing market has apparently stirred price reductions or service improvements. It has been impracticable to document the extent or duration of that improved treatment of customers. The changes, however, have clearly been in a beneficial direction from the point of view of customer interests (so long as the penetration of markets is not accomplished by predatory behavior), and may in the long run represent the strongest set of arguments for the bank holding company format.

Such benefits are most likely, of course, when the bank holding company is moving out of its existing markets and seeking to penetrate new ones. Consequently, bank regulatory authorities appear more inclined to approve ventures into new geographic markets than added acquisitions in local markets in which the applicant is already a significant participant.

To some commentators, the vision of a moderate number of large, strong and diversified bank holding companies spreading out in overlapping fashion in a multiplicity of geographical markets seems to promise a practical optimum in the competitive provision of banking and related services. To me, however, that vision is clouded by the attendant temptation to engage in oligopolistic behavior that may sometimes afflict firms facing each other in a number of markets. The more closely adjacent those markets are, and the fewer the organizations competing in each, the greater the temptation to oligopolistic behavior is likely to be.

Economic theorists have tried to conceptualize these intermarket relationships of firms in several ways. The concept of linked oligopoly is clearly applicable to these cases, and to some extent the more diffuse ideas of concentration of resources and conglomerate power can be made relevant. Other economic theories have emphasized what amounts to the other side of this same coin, namely, the beneficient competitive effect that can flow from strong firms close by that have not yet entered that particular market. The concepts of potential competition and, more recently, probable future competition, fall into this category.

Another and more novel concept of competitive discipline also seems to me to be applicable to these situations. That concept concerns the possibility that, if badly enough treated, customers of a bank in one market might be willing to travel to an adjacent market to seek banking services. I have articulated this idea -- labeled the "threat of customer exit" -- at greater length in the attached appendix, along with summaries of the economic and legal status of other concepts just mentioned. Suffice it to say here that such concepts of potential intermarket relationships among banking firms and their customers argue for caution in permitting bank holding companies to expand into geographical markets that are closely related. I believe that economic research is making it gradually clearer that competitive forces can flow from sellers of banking and related services in nearby markets. Therefore, in cases in which local competitors are not sufficiently strong and numerous to assure vigorous competition by themselves, preservation of additional banking organizations in nearby markets may help to promote competitive vigor.

Bank holding companies whose acquisitions are dispersed widely enough to avoid interfering with this pro-competitive influence from banks in nearby markets may be adopting the optimal long-run growth strategy from the point of view of the bank customer. Hopefully, enough research into this and related issues will have been stimulated to develop progressively clearer guidance in such judgments for banks, bank customers, and regulators alike.

IV.

It is clear that the bank holding company form of organization has become an important feature of the United States financial system in just a few years. In this paper, I have argued that the magnitude of the bank holding company movement, combined with its aggressive management, has significant implications for financial stability as well as for the stability (or degree of competition) of intermarket relationships among firms.

I have suggested that there are several actual or possible tendencies within the bank holding company movement that would generally be regarded as favorable to stability and several which are unfavorable. Thus, with respect to stability of financial institutions, favorable effects are associated with (1) holding company acquisition and support of some smaller, financially weak banks and nonbank firms that had a relatively high risk of failure, (2) their relatively aggressive community lending policy, and (3) their potential for diversification of risks across numerous markets and services. One major source of instability is associated with the relatively high degree of leveraging found in bank holding company organizations. Nonbank affiliates tend to be more highly leveraged than similar independent firms, and holding company banks themselves are often somewhat more leveraged than independent banks. This situation can be aggravated in those cases where double leveraging occurs at the holding company level. A second source of instability is the riskier quality of assets that some nonbank affiliates may bring into their bank holding company organizations.

With respect to the influence of bank holding companies on the stability of market relationships, the most pertinent questions arise from the multi-market dimensions of their activity. My review of the concepts that attempt to deal with firms in a multi-market setting indicates that some of these concepts view diversification as having a favorable (destabilizing) effect on interfirm relationships while others find an unfavorable (stabilizing) effect. I have added to this list of ideas by suggesting that, at least in some situations, exiting customers may be an influential agent in intermarket relationships between firms.

Research that would further illuminate the stability issues that I have raised in this paper could provide an important ingredient for the formulation of rational public policy toward the evolving role of bank holding companies in the American financial system. I sincerely hope that those of you in the academic community will find sufficient challenge and stimulation in these issues to apply your talents to them.

Appendix: Conceptualizing the Intermarket Relationships of Firms

Since Chamberlin's classic work on monopolistic competition, economists have devoted increased attention to the effects of varying market structures on the certainty or stability of the relationships between firms operating in the same market. Theory, combined with numerous empirical studies, indicates that as the number of firms in a market increases and concentration decreases, competitive performance improves. Within the Chamberlinian framework, this outcome is attributable to the increased uncertainty among firms as to their rivals' actions and reactions because of the larger number of market participants. In other words, it is easier for two or three firms to reach and maintain a mutually favorable agreement (overt or tacit) than it is for 100 firms. While this theoretical framework has been very useful for analysis of the interrelationships of firms operating in the same market, it is not directly applicable to the intermarket relationships of firms.

Consequently, the present state of the art provides us with inadequate insight into the competitive implications of bank holding company expansion into new product and geographic markets.

I will briefly review the economic and legal status of several concepts that have been developed to analyze the multi-market relationships of firms, including one with which I have recently been experimenting. The concepts include (1) potential competition, (2) probable future competition, (3) linked oligopoly, (4) conglomerate power and (5) the exploratory notion of what I call customer exit. To emphasize the lack of a systematic framework for analyzing multi-market firms, I might note that the first two concepts suggest, directly or indirectly, that diversification into new markets will provide a destabilizing, i.e., pro-competitive force. In contrast, the third and fourth concepts contend that substantial diversification by large firms results in increased stability of firm relationships within individual markets or groups of markets.

Theory of potential competition

The theory of potential competition holds that a firm outside a market (potential entrant) can have a pro-competitive influence on the pricing behavior of established firms in that market due to the threat of its entry. Actual entry need never occur for this influence to be manifested. This theory of the inter-market relationships of firms is the best known and most widely discussed in both economics and law. Indeed, it has been successfully applied by the antitrust authorities in contesting industrial mergers in the courts (e.g., the Proctor and Gamble Case, 1967; Penn-Olin Case, 1964; and El Paso Case, 1964), although it has not yet been successfully applied to bank mergers.

The theory of potential competition is based on two related concepts: barriers to entry and limit pricing. Barriers to entry are those characteristics (e.g., product differentiation and scale economies) of an industry that increases the costs of entry to all potential entrants, thereby permitting the established firms to charge higher than competitive-level prices without attracting new entrants. The limit price is the highest common price that sellers think they can charge without attracting a new entrant. A successful limit price policy by established firms requires that they price below that price at which the potential entrant can incur the costs of entry and still operate profitably.

Unfortunately, while there is a great deal of empirical analysis that has been done with respect to barriers to entry, there is virtually none on the concept of a limit price.

Probable future competition

The concept of probable future competition contends that a potential entrant may have a pro-competitive impact on a market because at some time in the future it may enter and deconcentrate the market. This concept was not developed in the economic literature but rather has evolved almost haphazardly in merger analysis, often being interjected in connection with discussions of the theory of potential competition. Nevertheless, there is a sound economic rationale for the application of this concept, since economic theory supported by a substantial body of empirical evidence suggests that increasing the number of firms so as to deconcentrate a market tends to induce more competitive performance.

As with its analytical development, the legal development of probable future competition has typically been haphazard, being comingled -- sometimes apparently inadvertently -- with discussions of the theory of potential competition. Recently, however, both regulatory authorities (including the Federal Reserve Reserve) and the courts have distinguished the concept of probable future competition from potential competition. Thus, for example, the concept of probable future competition has been brought out as a distinct issue in several recent Supreme Court cases, including Falstaff, Connecticut National Bank, and Marine Bancorporation. In the Falstaff case, the theory of potential competition (with established legal precedents) was applied by the Court so that it explicitly reserved a ruling on the separable issue of probable future competition. In the two subsequent bank cases, the Court considered probable future competition but gave it only limited treatment because of the limited evidence brought to bear on the issue.

In view of its relatively recent origins and its capacity for empirical documentation, the concept of probable future competition seems ripe for further economic and legal development.

Linked oligopoly

The linked oligopoly hypothesis observes that as the larger firms in various markets diversify into other markets they will meet face-to-face in an increasing number of markets. As a consequence, competitive actions in one market are not independent of other markets, since aggressive action in any one market may be countered by a rival with aggressive action in some other market where the two firms meet.

These large rivals become aware of their multi-market interdependence and common interests and may seek to avoid a competitive struggle in the same ways as traditional single-market oligopolists. In essence then, the hypothesis is an extension of basic oligopoly theory to a multi-market setting.

The linked oligopoly hypothesis has received comparatively little attention from antitrust authorities and economists. However, the Justice Department's recent concern with Statewide banking structure led it to apply the linked oligopoly hypothesis (along with potential competition and probable future competition) in the recent Marine Bancorporation and Connecticut cases before the Supreme Court. The Court rejected that argument on grounds of lack of evidence and legal precedent. It did not, however, issue a general condemnation of the linked oligopoly hypothesis. To my knowledge these are the first court tests of this hypothesis. It would appear, therefore, that in both economics and law the linked oligopoly hypothesis is in an early stage of development and there should be considerable opportunity for refining and applying it in the future.

Conglomerate power

The conglomerate power hypothesis was first articulated in the mid-1950's and has been a subject of debate ever since. This hypothesis holds that large conglomerate (diversified) firms have unique economic power accrue to them that is independent of monopoly power associated with individual markets. This conglomerate power may be manifested in certain forms of anticompetitive behavior, including cross-subsidization, reciprocity and tie-in arrangements. Because of the typically large size of diversified firms, this behavior, or its threat, is likely to inhibit aggressive behavior by smaller firms. While there is no evidence of a general nature regarding this type of conduct because of obvious data problems, there is some analytical and legal case evidence illustrating the occurrence of these practices.

The legal development of the specific issues raised by the conglomerate power hypothesis is rather complete, in that each of the forms of anticompetitive conduct outlined above are expressly prohibited by the antitrust laws and each has been accepted in the courts. The economic development of the concept is far from complete, largely because of inadequate theoretical development and a lack of product-line data on individual firms that would permit hypothesis testing of a general nature.

Threat of customer exit

To the foregoing list of more familiar concepts dealing with the intermarket relationships of firms, I believe one novel idea might usefully be added -- namely, the threat of customer exit. While the emphasis of the four concepts outlined above is on the direct relationship between sellers, the concept introduced here suggests that, at least in the banking industry, customers may exert a constructively destabilizing force by their express or implied threat to move from one market to another in search of more satisfactory services.[6/] Recent experience with

6/ Even though some customers travel to another "market", it does not necessarily imply that there is only one instead of two markets. The distinction between markets will depend on the extent to which long-run price differences can persist between them.

bank holding company acquisition cases suggests to me that this phenomenon may be most important between relatively small markets in which banking alternatives are limited. The following amplification of this concept may permit its applicability to be judged more accurately.

The traditional conception of the theory of potential competition contends that the price constraint created by a firm outside a market arises from the threat that the outside firm will enter the market. Even in those situations where the price-constraining influence of the threat of entry may be small, there is another avenue through which the outside firm exercises a restraining influence on the price behavior of established firms. This arises from the threat of customer exit. This threat continues to operate as a moderating force even when barriers to entry are high and the influence of potential entry is weak, because of the substantial cost differences between firm entry and customer exit.

The outside firm is faced with the high cost of overcoming entry barriers, information costs, uncertainty due to information and alternative reactions to entry, an irrevocable decision in the short-run, and a considerable time lag between decision to enter and implementation. In contrast, regardless of barriers to entry, customer exit can be accomplished rapidly, usually with little uncertainty as to the effect of exit, and the decision probably can be promptly reversed. The established firm in a market, in recognition of the potential exit of at least some of its customers, is likely to develop a <u>second</u> limit price to inhibit such customer exit. And, because the cost of customer exit is usually so much lower than that for firm entry, the limit price arising from the threat of exit should tend to be lower than the limit price associated with firm entry. The threat of exit may not be as powerful as the threat of entry, because actual entry could lead to a permanent loss of a whole range of customers whereas actual exit is most likely to involve only one class of "frontier" customers who could conceivably be lured back. However, if such a second and lower limit price develops, there will be a spillover effect to the advantage of all customers as a result of the leverage of the one class of potentially exiting customers.

The implications of this concept for bank merger policy is that banking organizations that may offer a reasonable alternative source of banking services to customers exiting from another market with few banks can be an important contributor to competitive behavior in that latter market. Accordingly, authorities should be wary of permitting such banking organizations to enter that other market by acquisition.

This concept of the threat of customer exit is very hypothetical, barely explored empirically and as yet untested in the courts. It seems to lend itself, however, to either large-scale or small-scale empirical investigation. That, and its potential implications for public policy, seem to me to make it a promising area for further economic research.

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