Bank Holding Companies and Data Processing

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Eleven months of experience with the 1970 Amendments to the Bank Holding Company Act have convinced most observers that while Congressional deliberations could produce neither a "clean" nor a "dirty" laundry list of activities related to banking, Congressional action did outfit the banking industry with what amounts to an attractive and varied addition to its wardrobe. But it is a wardrobe addition, I would hasten to add, on which there are important constraints as to the circumstances and extent of its use.

The Congressional hearings and deliberations in 1969 and 1970 achieved a clearer identification of the needed constraints and limitations imposed by the public interest on holding company activities than was apparent at the time. Although the amendments in final form were, in some respects, inconsistently described in the reports of the Congressional committees and although legislative historians and interpreters of Congressional intent will have numerous opportunities to dispute their application to particular situations, the Congressional intent on the major issues is clear.

The previously expressed legislative policy as to the hostile consequences to the public interest of undue concentration, anticompetitive affiliations, tie-in merchandising and the merging of commercial and banking interests was reinforced in the amendments. In these respects, the Congress left no doubt as to its concern nor of its intent that the Federal Reserve should not permit extension of bank holding company activities that would jeopardize the welfare of users of banking and financially related services.

On June 15, 1971, the Board of Governors announced an amendment to its bank holding company regulation outlining the kinds of data processing activities permissible for bank holding companies under the 1970 Amendments to the Bank Holding Company Act. That action was the culmination of Congressional and Board judgments on the issues involved in permitting holding companies to engage in this activity.

The bill originally passed by the House of Representatives would have expressly limited the kinds of data processing services that bank holding companies could offer, on the basis of section 4(c)(8) of the Holding Company Act, to data processing services that are incidental to banking services, such as the preparation of payrolls, or that are necessary to make economical use of equipment primarily acquired and used for the bank holding company or its bank subsidiaries.

Had the "negative laundry list" included in the HOuse bill been adopted, the Congress would have decided that other data processing activites are not closely related to banking. A provision of the bill stated that those other activities are neither necessary, incidental, nor related to carrying on the business of banking or of managing or controlling banks, and are not in the public interest as activities to be carried on by holding companies or subsidiaries thereof.

The Senate dropped the negative laundry list. With it went any specific limitations on the kinds of data processing activities that the Board might determine meet the test of the revised section 4(c)(8). That test is whether the activities are "so closely related to banking or managing or controlling banks as to be a proper incident thereto."

It is, I believe, a fair conclusion that the Congress delegated to the Board the authority to make the decision as to what kinds of data processing activities are proper activities for bank holding companies. But I do not mean to suggest that Congress gave the Board a free hand in this matter. On the contrary, it gave definite direction to the Board's determination.

Congress specifically provided in section 4(c)(8) that "In determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts or interests, or unsound banking practices."

Further to protect against adverse consequences of holding companies engaging in nonbanking activities, the Congress included provisions in the 1970 legislation specifically directed against the possibility of misuse of economic power of a bank.

Those amendments are commonly referred to as the anti-tying provisions. They express a specific statutory assurance that a bank may not use its economic power to lessen competition or engage in unfair competitive practices. They are intended to affirm in statutory language the principles of fair competition.

In essence the anti-tying provisions prohibit a bank from providing any credit, property, or service for a customer on the condition that he obtain from one of the bank's affiliates some additional credit, property, or service. In its first implementation of revised section 4(c)(8) of the Act, the Board expanded the scope of those provisions to include subsidiaries of holding companies approved by the Board under that section.

Consequently, under the provisions of the statute and of the Board's regulation, there are three basic contraints on bank holding companies' activities in data processing. Such activities must not result in (1) undue concentration of economic power, (2) decreased competition, or (3) unfair competition, unless such adverse effect is outweighed by benefits to the public in the form of greater convenience, lower costs, and the like. And section 225.4(c) of Regulation Y provides that a holding company's section 4(c)(8) subsidiary may not condition any credit, property, or services upon the customer obtaining some additional credit, property, or service from the subsidiary or any other affiliate in the holding company's subsidiary banks.

Unlike the situation before 1971, there is no geographic limitation on where a bank holding company may perform data processing activities on the basis of section 4(c)(8). Before 1971, the only substantive rule in the Board's regulation regarding bank holding companies was that activities approved under section 4(c)(8) must be closely related to the business of banking or managing or controlling banks "as conducted by such bank holding company or its banking subsidiaries". This was an unsatisfactory rule both because it made the kinds of permissible activities vary among holding companies and because it resulted in limiting the location at which permissible activities could be performed to the market area of the holding company's banking subsidiaries.

That rule was condemned by the Senate Banking Committee. In its Report on the 1970 legislation, the Committee observed that, in effect, "the business of banking" as used in former section 4(c)(8) of the Act was interpreted by the Board not to refer to the general business of banking itself but instead to the business of the particular banks within the particular bank holding company structure being considered. As the Committee concluded, the interpretation prevented holding companies from offering new services to new customers and, in some instances, may have served to inhibit competition.

Implicit in the Senate Committee's views and in the provisions of revised section 4(c)(8) is authority for the Board to remove geographic barriers to the performance by holding companies of nonbanking activities. In its original proposed implementation of the revised section 4(c)(8), the Board noted that its proposal did not limit the location at which permissible activities might be conducted to any State or other geographic area. It stated, however, that such limitations might be imposed by regulation, or by order in particular cases. When the Board adopted its initial list of permissible activities under section 4(c)(8) in May, 1971, it did not include geographic limitations by regulation.

In my view geographic limitations on holding company activities pursuant to section 4(c)(8) generally are hostile to the public interest because they sequester competitive forces instead of releasing them. Rather than attempting to confine a holding company's activities to the market area of its banking subsidiaries, a procompetitive policy would encourage a holding company to conduct its nonbanking activities beyond the market area of the holding company's banks. The farther away from that market those activities are conducted, the more certain it is they will add to the overall competitive environment.

The activities determined by the Board to be closely related to banking in its action announced in May relate essentially to typical activities in the intermediation process--mortgage lending, operating finance companies, factoring, servicing mortgages, and the like.

Adoption by the Board in June of its regulation regarding data processing activities was its first major action in the area of services that are not an integral part of the intermediation process. The significance of this action was underscored by the Board conducting a hearing on April 16 solely on the issues involved in deciding whether to permit holding companies to engage in data processing activities.

The Board had originally proposed to permit holding companies to provide bookkeeping or data processing services for (1) the holding company and its subsidiaries, (2) other financial institutions, and (3) others so long as the value of the services performed for those other persons did not become a principal portion of the total value of all data processing services performed.

After consideration of testimony at the hearing and the written comments, the Board decided to abandon the proposed quantitative description of permissible data processing services in favor of a qualitative description.

Specifically, the Board determined that the following activities are closely related to banking within the meaning of section 4(c)(8): (1) providing bookkeeping or data processing services for the internal operations of the holding company and its subsidiaries and (2) storing and processing other banking, financial, or related economic data, such as performing payroll, accounts receivable or payable, or billing services.

The Board accompanied its amendment with an interpretation expressing its intent. The Board stated that the amendment is intended to permit holding companies to process, by means of a computer or otherwise, data for others of the kinds banks have processed, by one means or another, in conducting their internal operations and accommodating their customers. It is not intended to permit holding companies to engage in automated data processing activities by developing programs either upon their own initiative or upon request, unless the data involved are financially oriented.

The Board spelled out three activities that it regards as incidental activities necessary to carry on the permissible data processing activities: (1) making excess computer time available to anyone so long as the only involvement by the holding company system is furnishing the facility and necessary operating personnel; (2) selling a byproduct of the development of a program for a permissible data processing activity; and (3) furnishing any data processing service upon request of a customer if such data processing service is not otherwise reasonably available in the relevant market area.

The amendment became effective July 1, 1971. Since that time, bank holding companies have been able to engage in data processing following compliance with procedures previously established by the Board to assure that the balance of the public interest factors the Board is required to consider in approving holding company activities or acquisitions on the basis of section 4(c)(8) is favorable.

Under those procedures, a bank holding company may engage in the specified types of data processing de novo 45 days after publishing notice of its proposal in newspapers in the areas it expects to serve, unless the company is informed by the Federal Reserve to the contrary within that time. A holding company may acquire a going concern to engage in the specified data processing activities only upon publishing notice and filing an application. An acquisition requires a determination by the Board that consummation of the proposal will be in the public interest, giving consideration to the relevant factors specified in section 4(c)(8) of the Act. The differentiation between de novo entry and acquisition of a going concern is justified because of the increase in competition by a new entrant into the market.

During the course of the Board's consideration of holding companies engaging in data processing, the Association of Data Processing Service Organizations (ADAPSO) urged the Board to adopt the doctrine of maximum separation of banks from data processing. It argued that without that separation banks would have an unfair competitive advantage over independent data processing companies because banks do not allocate the cost of performing data processing services for themselves fairly. Also, the volume of internal work performed by a holding company for its banks would enable it to offer services to others at lower rates than the independent company, unless and until that company had a volume equal to the bank's internal needs. ADAPSO recognized, however, that this pricing problem is not unique to holding companies entering the data processing field. It is inherent in all large companies entering the field, which may for some period of time have excess machine and personnel capacities.

ADAPSO attempted to differentiate between industry and bank participation in data processing on the grounds that banks have the power to create credit and industry often has trouble obtaining credit. The suggestion was that this would mean that data processing affiliates will be able to finance their operations easier than other data processing companies because the bank will extend them credit. However, apparently ADAPSO failed to consider section 23A of the Federal Reserve Act.

Section 23A restricts in two ways the authority of all Federally insured banks to lend financial assistance to affiliated organizations. The first paragraph forbids a bank to risk more than 10 per cent of its capital and surplus in prescribed kinds of transactions relating to any one affiliate (including any "extension of credit" to such affiliate) or more than 20 per cent in all such affiliate-related transactions. The second paragraph requires each loan or extension of credit to an affiliate to be fully collateralized by prescribed types of securities. Consequently, section 23A is one of the major protections against bank holding companies engaging in nonbanking activities in a manner contrary to the public interest.

The gist of the ADAPSO position was that banks have a built-in clientele of customers that need data processing services. The provisions of the regulation preventing a holding company nonbanking subsidiary from conditioning its services upon the customer obtaining a service from an affiliated bank guards against this type of problem. That protection should be adequate, if bank holding companies are prudent and exercise good business judgment.

By selling its data processing services for a fee separate from any other service, a holding company can avoid criticism and lessen the risk that the Board will require modification of the holding company's activities to assure that the balance of the public interest factors remains favorable to the company engaging in data processing services.

Other safeguards are available to holding companies seeking to protect themselves against charges of unfair competition. Along this line, a holding company that proposes to establish a data processing subsidiary might avoid the use of the name of its lead bank in the title of the company. Although in time potential customers would associate the data processing subsidiary with the bank, the company could not be critiziced for taking advantage of the advertising value of the name of its lead bank. The holding company might also wish to consider establishing the subsidiary outside the market area of the holding company's banking subsidiaries to help disassociate the data processing services from its banks.

Such factors as these are considered by the Federal Reserve in evaluating holding company proposals to engage in data processing on the basis of section 4(c)(8)--either by de novo entry or through acquisition of a going concern.

It is also necessary for the Federal Reserve to evaluate holding company proposals from the standpoint whether the proposed data processing activities involve banking, financial, or related economic data within the meaning of the Board's regulation.

Clearly, processing data relating to the production of goods and services is not permissible. Under the regulation, holding companies are also unable to develop data processing programs for airplane traffic control or reservations, golf or other sport scores or other statistics, consumer surveys, and the like.

The kinds of data processing that are permissible under the regulation does, however, encompass all of the kinds of data processing services in which the banking industry was engaged in 1969, when Congress began its consideration of the the one-bank holding company legislation. In addition to the specific activities referred to in the regulation, those services include sales analysis, inventory analysis, freight payment, municipal tax billing, credit union accounting, and savings and mortgage loan bookkeeping.

This reflects the Board's conclusion that if a service is a financial transaction processing service or a financial analytical service, it is a service closely related to banking regardless of who uses the service.

The role of data processing closest to my interest has to do with improvements in the payments mechanism and the latitude necessary for the banking industry to carry on the necessary research and development. Essentially, this is a matter of providing a skill base compensurate to the challenge inherent in a fully automated payment system. Because banks may not engage in data processing generally this fact could retard the development of vital skills. No one can say how large and how general a data processing involvement is needed but I would be prepared to argue that insofar as a given data processing activity can be related to this very vital function of banking it is of necessity closely related to banking.

TABLE I

Commercial Banks and Bank Holding Companies

June 30, 1971 (subject to revision)

Size of Bank (Total Deposits in billions)	All Banks		Banks outside of a Holding Company			
	No.	Total Deposits (billions)	No.	Total Deposits (billions)	Per cent	
					No.	Deposits
All banks	13,751	$507.0	11,692	$264.7	85	52
over $500	133	237.1	61	69.9	46	17
$100 - $500	457	94.2	276	54.0	60	57
$60 - $100	380	29.0	277	21.1	73	73
$10 - $60	4,999	109.7	4,059	86.6	81	79
Less than $10	7,782	37.1	7,019	33.0	90	89

Table II

Bank Holding Companies and Their Lead Banks

June 30, 1971 (subject to revision)

Size of Holding Company (Total deposits in billions)	All Holding Companies		Lead banks in Holding Companies
	No.	Total Deposits	Total Deposits
All Holding Companies	1,260	$244.5	$209.1
over $500	80	195.1	159.7
$100 - $500	137	31.9	31.8
$60 - $100	64	4.9	4.9
$10 - $60	414	9.7	9.7
less than $10	565	2.8	2.8