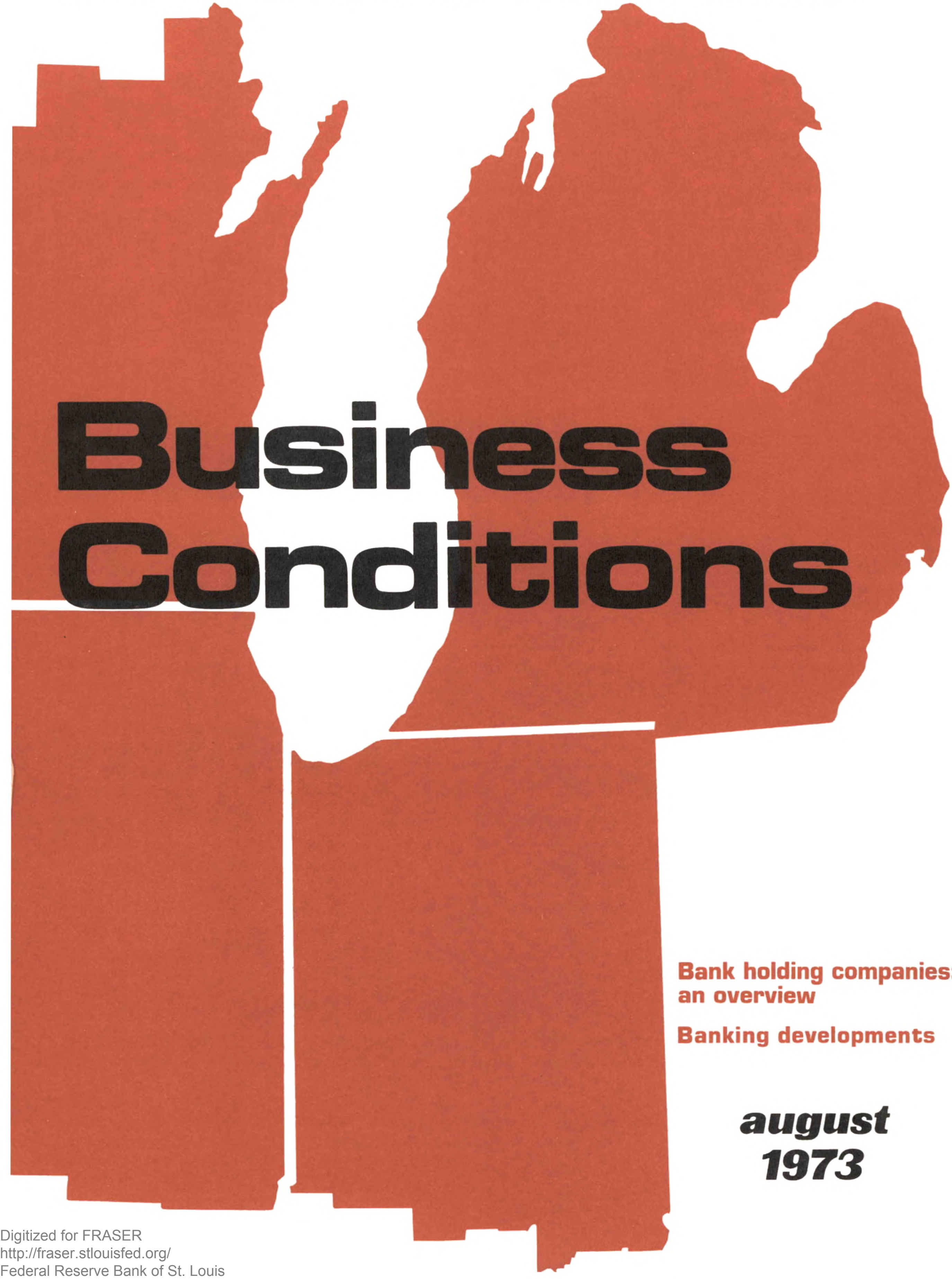
an economic review by the Federal Reserve Bank of Chicago



Business Conditions

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Banking developments

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Bank holding companies: an overview

Bank holding companies have commanded the attention of the banking community since the mid-1960s. Their prominence is attributable to two longstanding and important trends that gathered renewed momentum at that time: (1) the continuing expansion of multibank holding companies, in large measure as a means of achieving multiple office banking in the face of restrictive state branching laws; and (2) the sudden emergence of the one-bank holding company as a device used by the largest banks in the country to diversify into nonbanking activities.

With the passage of the 1970 amendments to the Bank Holding Company Act of 1956, previously unregulated one-bank holding companies were required to register and disclose the nature and extent of their nonbanking activities, and with registration it became possible for the first time to obtain a comprehensive overview of the one-bank holding company movement. The purpose of this article is to provide a brief description of the trends that resulted in the passage of the 1970 amendments and present some detail on the current status and prospects of bank holding companies, both nationally and in the Seventh District.

Developments to 1970

Although bank holding companies have a history that stretches back beyond the turn of the century in the United States, they have grown by fits and starts and have experienced a number of important setbacks. Widespread bank failures during the Depression triggered a move away from the holding company form of organization that carried into the postwar years. The number of multibank holding companies declined from a high of 97 at the end of 1931 to a low of 20 at the end of 1948. During most of the 1931-48 period, multibank holding companies controlled about 7 percent of all banking offices and held between 11 and 14 percent of all commercial bank deposits.

Despite this period of decline, the Board of Governors of the Federal Reserve System viewed bank holding companies with concern and made legislative recommendations to Congress as early as 1943. It was the Board's contention that bank holding companies were being used as a corporate device to evade the intent of Congress [expressed in the Banking Act of 1933 (as amended)] that banks should not engage in business activities unrelated to banking. Congress, said the Board, should restrict bank holding company expansion to prevent bank holding companies or their affiliates from doing what their subsidiary banks—or indeed any individual bank—were prohibited from doing under the provisions of the 1933 act.

Congress paid little attention to the Board's pleas at that time; it was not until 1956 that the first comprehensive federal regulation of multibank holding companies became effective. The Bank Holding Company Act of 1956 required the Board to weigh several competitive, managerial, and financial criteria in determining whether to approve or deny applications by multibank holding companies to acquire additional banks. The act also limited nonbanking activities of multibank holding companies to the performance of services that were "a proper incident to" banking or managing or controlling banks and, in addition, were "of a financial, fiduciary or insurance nature."

Following the passage of the act, the number of multibank holding companies continued to decline until 1962, while the number of banking offices and the volume of deposits controlled by these companies merely kept pace with the growth of the banking system. But in 1966, the number of multibank holding companies increased from 48 to 58, and their share of deposits grew from 8 to 12 percent that year alone. By the end of 1970, they numbered 121 and controlled more than 16 percent of U. S. commercial bank deposits.

The rise of one-bank holding companies

The Bank Holding Company Act of 1956 defined a bank holding company as a company controlling two or more banks. Although Congress was aware of the existence of one-bank holding companies, the 1956 act completely ignored them, probably because of their unimportance at the time. Since one-bank holding companies were exempt under the 1956 act, they were totally unrestricted as to the types of business activities in which they could engage. However, because one-bank holding companies increased in number only moderately in the ten years following passage of the 1956 act and confined themselves primarily to financial activities, Congress again exempted the one-bank form from coverage when it amended the Bank Holding Company Act in 1966.

Rather ironically, it was in 1966 that the rate of new one-bank holding company formations suddenly began to accelerate. Between January 1, 1966 and June 30, 1968, 201 new one-bank holding companies were organized—a 47 percent increase over the number previously in existence. This trend continued as the number of one-bank holding companies expanded between July 1, 1968 and year-end 1970 by 690, an increase of 110 percent.

The explosive increase in new formations was overshadowed in potential significance by the expanding range of activities unrelated to banking being entered by one-bank holding companies. For example, at the time Congress passed the 1970 amendments, there were one-bank holding companies engaged in approximately 100 different nonfinancial activities, ranging from agricultural and mining operations to various types of manufacturing, transportation, and wholesale and retail trade. Between 1960 and 1970, one-bank holding companies whose primary activities were unrelated to banking fell continuously from 66 percent to 54 percent of the total. In absolute terms, however, their numbers continued to increase. By 1970, there were 715 such companies and they controlled over 5 percent of U. S. commercial banks. (For an expanded discussion of nonbanking activities of one-bank holding companies see page 5.)

An additional problem was that many of the nation's largest banks were among those affiliated with one-bank holding companies whose business activities were unrelated to banking. On December 31, 1970, there were 162 one-bank holding companies that controlled banks having deposits exceeding $100 million, and about 70 percent of those companies were engaged in activities not closely related to banking. By contrast, only 8 percent of the one-bank holding companies controlling banks in the same size-class were engaged solely in banking.

Because many large and small businesses, as well as individuals, are dependent upon bank credit for their working capital, this breach in the traditional separation between banking and commerce led to widespread demand for immediate action to halt the one-bank holding company movement in its incipiency, or at least to subject it to public control. Congress responded to this demand by enacting the Bank Holding Company Act Amendments of 1970. At the end of 1970, 1,352 one-bank holding companies held over one-

Nonbanking activities

One of the main purposes for requiring the registration of one-bank holding companies was the desire of Congress and the bank regulatory agencies to know more precisely how many one-bank holding companies were financial congenerics—i.e., companies whose activities extended beyond the traditional limits of banking but remained within the financial area—and how many were conglomerates—i.e., companies engaged in activities totally unrelated either to banking or to financial areas that were closely related to banking.

Nonbanking activities of Seventh District one-bank holding companies that registered under the 1970 amendments range from those closely related to banking, such as safe deposit and consumer finance companies, to those as far afield as steel fabricating and the manufacturing of telephone equipment. As might be expected, the highest concentration of nonbanking activities occurred in the areas of finance, real estate, and insurance. While the range of activities engaged in by Seventh District one-bank holding companies far exceeds those mentioned specifically in this article, the number of different activities engaged in by district companies was about half that for one-bank holding companies in the nation.

A holding company is considered to be in "banking only" if it performs only traditional banking services. Among the few nonbanking activities this type of holding company might engage in are owning a bank building or other facility used by its bank subsidiary, conducting a safe deposit business, or providing management services solely to its bank subsidiaries.

A holding company is classified as "closely related to banking" if its nonbanking activities are limited to those on the permissible list. A holding company is classified as "not closely related to banking" if it engages in *any* activity not specifically listed among the 16 permissible activities. In short, a three-way classification—holding companies that are in "banking only," those "closely related to banking," and those "not closely related to banking"—reflects the Board's interpretation of the intent of Congress in amending the act and thus provides information about the extent of diversification of one-bank holding companies at the time of the 1970 amendments.

On December 31, 1970, 114 of the 334 Seventh District one-bank holding companies were engaged solely in banking activities (34 percent), while 83 were engaged in some nonbanking activities that were deemed "closely related to banking" (just under 25 percent). The remaining 137 holding companies were engaged in one or more nonpermissible activities and thus were classified as "not closely related to banking" (41 percent).

The three-way classification utilized in this article provides a very rough indication of the division of Seventh District one-bank holding companies between congeneric and conglomerate types. Obviously, the 114 "banking only" holding companies were basically banks and neither the congeneric nor conglomerate label applies. While all of the 83 companies in the "closely related to banking" category were, by definition, congeneric in nature, not all of the 137 companies in the "not closely related to banking" classification were conglomerates. Of these, 86 were conglomerates and 51 were congenerics on December 31, 1970. A company was considered congeneric if its nonbanking activities were either in the areas of finance, insurance, and real estate or were related thereto: e.g., leasing, data processing, and management consulting. Holding companies engaged in agriculture, mining, construction, manufacturing, transportation, communication, wholesale or retail trade, or services unrelated to the financial area were classified as conglomerate.

third of the commercial bank deposits in the United States, while 121 multibank holding companies controlled 895 banks with one-sixth of all bank deposits.

The 1970 amendments

The 1970 amendments changed the definition of a bank holding company, and also changed the definition of a "company." Under the 1956 act, a bank holding company was defined as "any company (1) that directly or indirectly owns, controls, or holds with power to vote 25 percentum or more of the voting shares of each of *two or more banks* . . . or (2) that controls in any manner the election of a majority of the directors of each of *two or more banks* . . .." The 1970 amendments eliminated the legal distinction between one-bank and multibank holding companies by defining a bank holding company as "any company which has control over *any bank* or over any company that is or becomes a bank holding company . . .." Also, the Board of Governors of the Federal Reserve System was given leeway to extend the definition of control to meet special situations. Specifically, the Board was given discretionary power to determine that ownership, control, or power to vote as little as 5 percent of the shares of a company or a bank could constitute control.

The definition of a "company" was extended to include partnerships, in addition to corporations, business trusts, associations, and similar organizations included in the 1956 act. The new definitions of "company" and "control" gave the Board effective regulatory powers over chains of banks controlled through de facto or de jure partnership arrangements.

Another major provision of the act revised by the 1970 amendments—Section 4(c)(8) listing the criteria which nonbanking activities must meet to be permissible for bank holding companies—laid the ground rules for determining the scope of

Permissibility of nonbanking activities for bank holding companies under Section 4(c)(8)

Activities APPROVED by the Board

1. Dealer in bankers' acceptances
2. Mortgage company
3. Finance company
4. Credit card company
5. Factoring company
6. Operating an industrial bank
7. Servicing loans
8. Trust company
9. Investment adviser to real estate investment trusts and to investment companies under the Investment Company Act of 1940.
10. Furnishing general economic information and advice
11. Providing portfolio investment advice
12. Full pay-out leasing of personal property
13. Investments in community welfare projects
14. Providing bookkeeping or data processing services
15. Acting as insurance agent or broker—primarily in connection with credit extensions
16. Underwriting credit life insurance

Activities DENIED by the Board

1. Equity funding (the combined sale of mutual funds and insurance)
2. Underwriting general life insurance
3. Real estate brokerage
4. Land development
5. Real estate syndication
6. Management consulting
7. Property management

Activities UNDER CONSIDERATION by the Board

1. Leasing real property
2. Armored car and courier services
3. Mortgage guarantee insurance
4. Management consulting for nonaffiliated banks
5. Savings and loan associations

SOURCE: Regulation Y, *Federal Reserve Bulletin* and Robert J. Lawrence, "The Effect of Bank Holding Company Growth on the Correspondent Banking System," Table 4, in speech delivered at ABA Correspondent Banking Seminar, New Orleans, Louisiana, October 31, 1972.

future changes in the nation's financial structure. Rather than proscribe certain activities by use of a "laundry list" of prohibited activities, Congress gave the Board of Governors authority, subject to court review, to determine the outer limits of bank holding company diversification.

Section 4(c)(8) established a two-part test which all activities must meet in order to be exempted from outright prohibition as a nonbanking activity. Under this section, the Board must first determine whether an activity is "so closely related to banking or managing or controlling banks as to be a proper incident thereto"; and second, whether the performance of this activity "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 of interests, or unsound banking practices."

The wording of Section 4(c)(8) represented a compromise between the widely divergent views of the House and the Senate, thus making unclear the "intent of Congress" with regard to the meaning of "closely related to banking." Indeed, it would not be unfair to say that Congress "passed the buck" to the Board, and ultimately to the U. S. Supreme Court in the determination of what is "closely related to banking."

Implementing the 1970 amendments

As of January 1, 1973, the Board had approved 16 activities in which bank holding companies could engage. These activities can be condensed into eight principal categories: the extension and servicing of credit, trust functions, provision of investment or financial advice, personal property leasing, community welfare investments, data processing, acting as an agent in the sale of insurance related to credit extension, and underwriting credit life insurance.

The Board has never specified the criteria it has used to determine whether an activity is closely related to banking. Based on the Board's decisions to date and on statements by the Board's staff:

> It appears that an activity may be found closely related to banking if it meets any of the following criteria: (1) the activity is one in which banks have been engaged for a long time (e.g., trust services); (2) the activity involves either the issuance of deposits or lending (e.g., consumer finance and mortgage banking); (3) the activity is complementary to some banking services (e.g., acting as an agent in insuring a loan made by the bank subsidiary); and (4) the activity involves skills that banks clearly possess (e.g., data processing services).[1]

Although each of the above criteria provides a sufficient condition for an activity to pass the "closely related" test, a particular activity might meet one or all of these criteria and still fail to pass the "net public benefits" test of 4(c)(8). Such is the case for the eight activities which the Board has specifically ruled are not permissible bank holding company activities.

The Board is still considering the status of several other activities, including the leasing of real property, armored car and courier services, mortgage guarantee insurance, management consulting for nonaffiliated banks, and the control of savings and loan associations. This list does not, by any means, exhaust the possible activities in which bank holding companies may be

[1] Samuel H. Talley, "Developments in the Bank Holding Company Movement," in *Proceedings of a Conference on Bank Structure and Competition, 1972,* Federal Reserve Bank of Chicago, p. 7.

State by state review

Illinois. One-bank holding companies in Illinois accounted for almost one-half of the state's deposits at year-end 1970, while the state's single multibank holding company (domiciled in another state) accounted for less than one-half of 1 percent.

Indiana. Deposits of the subsidiary banks of one-bank holding companies in Indiana represented 26.3 percent of commercial bank deposits at year-end 1970. However, because of the state's prohibition of multibank holding companies. no Indiana banks are subsidiaries of multibank holding companies.

Iowa. Both multibank and one-bank holding companies are important in Iowa. As of December 31, 1970, multibank holding companies controlled 10.8 percent of deposits in the state. As of June 30, 1971, one-bank holding companies controlled 25.9 percent of the state's deposits.

Michigan. Because ownership of banks by domestic corporations was prohibited by state law until 1971, few holding companies existed in Michigan prior to a statutory change. Of those holding companies that had been formed, most involved small banks whose deposit size was less than $15 million. It was not until 1972 that the major banks in Detroit and other large metropolitan areas in the state began to organize one-bank holding companies. Although there were no multibank holding companies in Michigan at year-end 1970, several one-bank holding companies have since become multibank holding companies for the purpose of expanding their market areas beyond the 25-mile radius within which branching is allowed under state law.

Wisconsin. Multibank holding companies have been legal in Wisconsin for many years. Because the state's largest banks had formed their own holding companies years ago, only a few institutions had been attracted to the one-bank holding company form of organization as of year-end 1970. At year-end 1970, 43.4 percent of the state's deposits were accounted for by subsidiaries of multibank holding companies.

Bank holding companies in the Midwest—December 31, 1970

	Multibank holding companies					One-bank holding companies				
	Number of MBHCs	Number of subsid. banks	Total MBHC deposits (mil. dol.)	Share of state's deposits (percent)	Share of total banks (percent)	Number of OBHCs	Number of subsid. banks	Total OBHC deposits[1] (mil. dol.)	Share of state's deposits[1] (percent)	Share of total banks (percent)
Ill.	1	3	84	0.2	0.3	142	133	17,193	46.8	12.0
Ind.	–	–	–	–	–	24	21	2,887	26.3	5.9
Ia.	3	25	717	10.8	3.8	136	122	1,770	25.9	17.9
Mich.	–	–	–	–	–	27	20	948	4.3	6.4
Wisc.	16	82	4,200	43.4	13.6	32	30	532	5.3	5.0
Total	**20**	**110**	**5,001**	**6.1**	**3.5**	**361**	**326**	**23,330**	**27.0**	**10.5**

[1] June 30, 1971.

permitted to engage in the future since applications may be submitted involving activities not yet considered by the Board. Indeed, a holding company may apply for an activity already declared nonpermissible, but the applicant must be prepared to present evidence not considered earlier by the Board.

With only a few exceptions, the list of approved bank holding company activities consists of activities that banks themselves already could have performed under existing state and national banking laws. It seems fair to conclude that the Board has been reluctant to allow bank holding companies to perform activities outside the traditional banking umbrella and that the passage of the 1970 amendments, as yet, has done little to unfetter the banking system. Holding companies are still prohibited, with few exceptions, from offering any truly new or innovative services.

With respect to geographical diversification, however, Section 4(c)(8) has lifted all barriers to bank holding company expansion. This freedom to diversify geographically may eventually lead to deconcentration of local markets. For example, a Chicago-based holding company has acquired a trust company in Florida; an Indianapolis-based holding company has established leasing operations in the Chicago and New York areas; and a Hartford-based holding company has established a mortgage banking subsidiary in Chicago. Whether this breakdown of traditional geographic restrictions will be carried over to banking in the future is, of course, unknown. However, the entire issue of state restrictions on branch banking should receive intensive review by Congress in the near future in light of the Hunt Commission's recommendation that, "by state laws, the power of commercial banks to branch, both de novo and by merger, be extended to a statewide basis . . .."[2]

[2] *The Report of the President's Commission of Financial Structure and Regulation,* pp. 61-62.

Growth of one-bank holding companies in the Midwest

The growth of one-bank holding companies in the Seventh District states—Illinois, Indiana, Iowa, Michigan, and Wisconsin—paralleled the growth of the movement in the nation. The number of one-bank holding companies in district states increased only slowly until the mid-1960s, but in 1966 the rate of new holding company formations began to accelerate. Of the 334 banks that registered as subsidiaries[3] of Seventh District one-bank holding companies pursuant to the 1970 amendments, only 13 and 18, respectively, were holding company subsidiaries in 1950 and 1960. Despite an accelerated rate of increase in the early 1960s, still only 69 district banks had become subsidiaries of one-bank holding companies by year-end 1965.[4]

In the five Seventh District states, the proportion of banks that are subsidiaries of one-bank holding companies appears to be directly proportional to the restrictiveness of the states' branching laws. Illinois and Iowa permit only limited-service facilities in addition to a bank's main office. About 12 percent of Illinois banks and just under 18 percent of Iowa banks were subsidiaries of one-bank holding companies as of June 30, 1971. By contrast, just under 6 percent of the banks in Indiana, where countywide branching is permitted, were controlled by one-bank holding companies. In Wisconsin and Michigan, where branching can extend beyond the home county within a 25-mile radius of the home office,

[3] Because a bank holding company does not always exercise effective control over a subsidiary bank, this aggregate number of one-bank holding companies may be misleading. For more detail on "Defining control: subsidiaries and nonsubsidiaries," see p. 13.

[4] These numbers include only banks owned by one-bank holding companies which registered with the Board in 1971; they exclude banks owned by one-bank holding companies formed earlier but dissolved prior to 1970.

Asset size of Seventh District one-bank holding companies by class of company—December 31, 1970

Class of company	Total	Number of companies asset size *(million dollars)* Less than 5	5-10	10-50	50-500	500 and over	Assets *(million dollars)* Total, all companies	Average per company
Banking only	114	103	8	3	–	–	231.1	2.0
Closely related to banking	83	67	7	6	2	–	977.0	11.8
Not closely related to banking	137	81	16	20	12	8	8,692.4	63.4
Total	**334**	**251**	**31**	**29**	**14**	**9**	**9,900.5**	**29.6**

only 5 and a little over 6 percent, respectively, of the total number of banks were controlled by one-bank holding companies.

Size of district holding companies

The average asset size of Seventh District one-bank holding companies—a shade under $30 million at year-end 1970—could best be described as small.[5] Of the 334 Seventh District one-bank holding companies that registered as a result of the 1970 amendments, over 75 percent, or 251, had assets of less that $5 million, while slightly more than 4 percent, or 14 companies, had assets in excess of $100 million. Nationally, the average asset size of a one-bank holding company was just over $60 million—twice that of the district.

Based on the activities in which they engaged at year-end 1970, the one-bank holding companies in the Seventh District have been separated into three categories: (1) banking only, (2) closely related to banking, and (3) not closely related to banking. The separation is based on the activities considered to be permissible or nonpermissible under the Board's Regulation Y as of January 1, 1973.

[5] The median asset size of district one-bank holding companies was slightly less than $2 million at year-end 1970. This compares with a national median asset size of approximately $3 million.

Of the bank holding companies that registered following the 1970 amendment, the greatest concentration of small holding companies occurred in the "banking only" group. More than 90 percent of these—103 of 114 holding companies in this group—had assets of less than $5 million; indeed, 60 of them had assets of less than $1 million. The small average asset size of these holding companies reflected the fact that they engaged in no activities other than banking and that they tended to control small banks—of the 105 banks controlled by these 114 companies, almost 90 percent had deposits of less than $50 million on June 30, 1971.

The average asset size of holding companies engaged in activities "closely related to banking" was $11.8 million. These companies tended to control larger banks than those controlled by the "banking only" group—the average deposit size of the banks controlled by the "closely related to banking" group was approximately four times that of the "banking only" group. Because most of these companies engaged in several activities in addition to their banking activity, their total assets had to exceed their banking assets.

The average asset size of those holding companies engaging in one or more activities "not closely related to banking" was

$63.4 million. The average size of these companies far exceeded the average size of the companies in the other two categories not because of control over large banks but rather because of the involvement of these companies in activities unrelated to banking. The average deposit size of banks controlled by one-bank holding companies in this group was $90 million. The large average deposit size of the bank subsidiaries of companies in this group was greatly influenced by the deposit size of the one or two largest banks in the group; to a lesser extent, this same distortion occurred in the other groups, too.[6]

Bank deposit size

The average deposit size of bank subsidiaries of Seventh District one-bank holding companies was $76 million on June 30, 1971, compared to an average deposit size of $146 million for bank subsidiaries of one-bank holding companies in the nation as a whole. As with asset size, the few largest holding companies in the Seventh District states tended to dominate and inflate these averages.

The disparity between the average sizes of bank subsidiaries of holding companies in the district and in the nation was not unexpected since the average bank in the district is only 85 percent as large as the average bank in the nation. It should be noted, however, that banks affiliated with one-bank holding companies, both in the district and in the nation, tended to be larger, on average, than banks that were not affiliated with one-bank holding companies. In the Seventh District, the average bank subsidiary of a one-bank holding company—as measured by deposits—was more than twice as large as the average size bank in the district. For the United States, the average bank subsidiary of a one-bank holding company had almost four times the deposits of the average bank in the nation.

Overall, the Seventh District accounted for more than its share of banks affiliated with one-bank holding companies. With only 18.7 percent of all commercial banks in the United States in 1970, the Seventh District accounted for 23.4 percent of the total number of banks affiliated with one-bank holding companies.

[6] When the two largest banks are removed from the totals, the average deposit size of the bank affiliates of the "not closely related to banking" companies is reduced from $90 million to $43 million. Obviously, the relatively large amount of assets controlled by these companies was accounted for by their nonbanking activities, in particular, those activities outside the financial area such as manufacturing, mining, transportation, and wholesale and retail trade.

Deposit size of subsidiary banks affiliated with Seventh District one-bank holding companies by class of company—December 31, 1970

		Number of banks total deposit size *(million dollars)*					Deposits June 30, 1971 *(million dollars)*	
Class of company	Total	Less than 5	5-10	10-50	50-500	500 and over	Total, all banks	Average per bank
Banking only	105	14	27	53	11	–	2,969.9	28.3
Closely related to banking	76	26	15	25	6	4	9,167.4	120.6
Not closely related to banking	122	21	30	40	29	2	10,942.9	89.7
Total	**303**	**61**	**72**	**118**	**46**	**6**	**23,080.2**	**76.2**

Developments since 1970

Bank holding company activity in the Seventh District has continued at a high level since the passage of the Bank Holding Company Act Amendments of 1970. In the period of January 1, 1971 through June 30, 1973, 56 bank holding companies controlling 64 banks with aggregate deposits of $23.3 billion were formed. Only three district applications for new bank holding companies were denied by the Board of Governors during this period.

Aided by the enactment in April 1971 of a law permitting ownership of bank stock by Michigan corporations, Michigan led the district states with 22 new bank holding company formations during the January 1971 through June 1973 period. In second place was Iowa with 14 new holding companies, nine of which were formed in the first half of 1973. Illinois ranked third with 12 formations.

Acquisitions of additional banks by existing bank holding companies were confined to those district states permitting multibank holding companies. Of the 46 banks acquired by existing bank holding companies in the Seventh District between January 1, 1971 and June 30, 1972, 23 were acquired by 12 Wisconsin companies, 12 by four Iowa companies, and 11 by six Michigan companies. Only three such applications were denied.

Since the passage of the 1970 amendments, the rate of growth of new bank holding companies in the Seventh District states has been approximately half that experienced in the nation as a whole. Between year-end 1970 and December 31, 1972, the number of bank holding companies in the United States expanded by just over 9.1 percent, while in the five states comprising this district the rate of expansion was only 4.7 percent.

Under simplified rules established by the Board of Governors, applications to establish new firms (de novo entry) to engage in activities already declared permissible, as opposed to the acquisition of a going concern, are approved on an expedited basis by the individual Reserve banks.

From January 1971 through June 1973, 122 such de novo entries by Seventh District bank holding companies were approved by the Federal Reserve Bank of Chicago. Wisconsin accounted for the largest number of these, 34, ten of which were to engage in leasing activities. Indiana followed with 32 notifications. Illinois was third with 27 notifications, of which 11 involved commercial or consumer finance. For the entire district, the activities most frequently entered de novo between January 1971 and June 1973 were: leasing (21), mortgage banking (19), commercial finance (18), consumer lending (16), insurance (14), and investment advising (13).

Bank holding companies may also enter permissible activities through acquisition of existing firms. In contrast to de novo entry, however, proposed acquisitions require a detailed formal application and are subject to a rigorous examination with respect to their competitive and public interest effects. Between January 1971 and June 1973, nine applications by district holding companies to acquire companies engaged in permissible activities were approved. Acquired were two leasing companies, three mortgage companies, one trust company (in Florida), two consumer finance companies, and one credit card company. Two applications involving the retention of several nonbanking activities were also approved. One 4(c)(8) application was denied. Applications are still pending to enter the following activities not yet on the Board's permissible list: mortgage guarantee insurance, real property leasing, management consulting for banks, and operating savings and loan associations.

In summary, the passage of the 1970 amendments closed the "one-bank loophole" as well as several others, and brought all bank holding companies under the regulatory authority of the Board of Governors of the Federal Reserve System. As of year-end 1972, bank holding companies controlled 42.1 percent of all banking offices in the United States and 61.5 percent of total U. S. commercial bank deposits. They also engage in many activities that are closely related to banking such as leasing, mortgage banking, consumer and commercial finance, and data processing, and, by virtue of certain "grandfather" privileges, many activities that are totally unrelated to banking. Bank holding companies, in short, are an integral part of the evolutionary changes that have taken place in the U. S. banking and financial structure.

Harvey Rosenblum

Defining controls: subsidiaries and nonsubsidiaries

According to the 1970 amendments, a bank is not considered a subsidiary of a bank holding company unless the holding company owns, controls, or has power to vote at least 25 percent of the shares of that bank, or unless it is obvious that the holding company controls the election of a majority of the board of directors of the bank. Under certain circumstances, however, a holding company may be presumed to control a bank by virtue of its ownership, control, or power to vote as little as 5 percent of the shares of a bank.[1] Because such a bank may really be a subsidiary, the Board required bank holding companies to provide information on any bank in which they owned at least a 5 percent interest.

As of year-end 1970, of the 358 one-bank holding companies in Illinois, Indiana, Iowa, Michigan, and Wisconsin, 37 had nonsubsidiary banks (i.e., banks in which they controlled at least 5 percent but less than 25 percent of the outstanding stock), some of which may be deemed to be subsidiaries. Many of these holding companies had a less-than-25 percent interest in more than one bank and the maximum number of such nonsubsidiary banks for any single holding company was seven. A total of 50 district banks were identified as nonsubsidiaries, a number of them by more than one holding company.

Slightly more than one-fifth of the subsidiary banks of district one-bank holding companies were minority-owned (i.e., holding companies owned between 25 and 50 percent of the voting shares). The remaining four-fifths were majority-owned. Of these, about one-fourth involved over 90 percent ownership.

The fact that more than one-fifth of the subsidiary banks were minority-owned is significant because it is possible that, in reality, some of these banks may not be controlled by their respective holding companies. Although 25 percent ownership is sufficient to define control under the act, it may not be sufficient to provide effective operating control. Consider, for example, the case in which a corporation owns 25 percent of the bank's shares and an individual owns the remaining 75 percent. Under the act, the corporation is considered a bank holding company controlling that bank. The corporation becomes subject to the restrictions of the act while the individual exercising operating control over that bank is free from the act's provisions.

[1] The circumstances under which control may be presumed are spelled out in great detail in Section 225.2 of Regulation Y.

Banking developments

Federal funds—record rates and volume

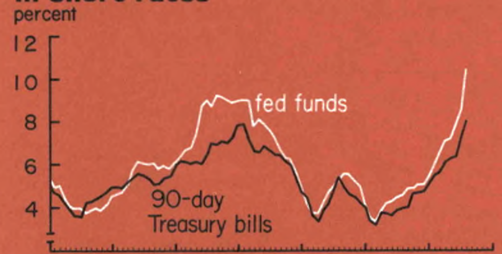
Historically high rates in the market for federal funds in recent months have been coupled with record trading volume. In the week ended August 29, the "effective" federal funds rate (based on the volume of transactions at various rates as reported by brokers to the Federal Reserve Bank of New York) averaged 10.79 percent on an annual basis, well above the 1969 high of 9.68 percent, and up about 500 basis points from the start of this year. Figures available on the transactions of about 50 major money market banks show that their gross purchases averaged over $14 billion per day in August—up about 5 percent from August 1972 levels and about double the 1969 peak volume.

Federal funds transactions are one-day loans from one bank to another, effected mainly through transfers of member bank deposits (reserve balances) at Federal Reserve banks. Selling banks authorize immediate transfers of funds to buying banks, which use the funds on the day of transfer and repay the following day.

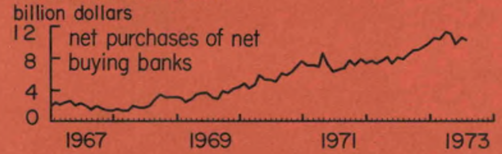
Member bank reserve accounts serve as working balances, through which all kinds of bank and customer transactions clear, as well as satisfying legal reserve requirements. Flows of funds within the banking system are constantly changing the distribution of these balances among banks, although the total is controlled by the Federal Reserve System through its open market operations.

Since reserve balances are nonearning assets, all banks try to minimize weekly average deviations from the legally required amount. The fed funds market provides a means of achieving this objective. Furthermore, when loan demand is high and monetary policy is aimed at slowing credit expansion, many banks find that inflows of funds from normal sources—customer deposit growth, loan repayments, etc.—persistently fall below the outflows that result as deposits credited to loan customers are drawn upon and the proceeds are deposited in other banks. There are many ways a bank can bridge this gap, including selling or borrowing on securities, issuing certificates of deposit, acquiring Eurodollars, selling loans to an affiliate, or continuously purchasing fed funds on a daily basis. The choice will depend largely on the length of time the bank foresees its needs will persist, and on differences in the relative costs of the alternative sources both currently and, depending on the bank's views as to the general trend of interest rates, over the months ahead. Be-

Fed funds pace fluctuations in short rates



Large banks use fed funds more than ever



*Data are averages of daily interbank fed funds transactions reported by 46 large banks.

cause the federal funds market is the interface between banks' demand for reserves and the overall amount supplied, the fed funds rate tends to lead other money market rates in both directions and to show greater swings over the interest rate cycle. (See chart.)

This year's upward pressure on money market rates, especially the fed funds rate, reflects strong loan demand relative to the rate at which bank reserves have been supplied through Federal Reserve open market operations. During the first half of 1973, total loans at all U. S. commercial banks increased at a seasonally adjusted annual rate of 21 percent, compared with 14 percent in the first half of 1972 and 18 percent for all of 1972. Meanwhile, nonborrowed reserves—reserves supplied by open market operations in combination with technical factors but excluding borrowings at Reserve bank discount windows—rose at a 5 percent rate in the first half of this year, compared with 7 percent for all of last year. The initial impact of these forces was to cause member banks to look to the discount window to meet their residual needs. Member bank borrowing from Federal Reserve banks averaged more than $1.6 billion in the first six months of 1973—almost three times the daily average for the last six months of 1972. However, since individual banks cannot rely on such borrowing as a continuous source of funds, bidding for federal funds also grew more aggressive, driving the rate higher.

There is no comprehensive measure of the total amount of fed funds transferred on the average day. On balance, the 46 large U. S. banks that report their transactions daily absorbed $9.3 billion net through this market on the average day in the first half of 1973, compared with $6.8 billion per day in 1972. Thirteen New York and Chicago banks accounted for 63 percent of the 1973 net purchases, down from 73 percent in 1972.

The counterpart of every purchase is a sale. As the above figures indicate, large banks tend to be net buyers of federal funds. Smaller banks tend to be net sellers, and higher rates have elicited increased sales. Gross purchases of funds by all district banks except the eight money market banks averaged $1.7 billion per day in the first half of 1973, compared with $1.2 billion in 1972. The number of these banks reporting purchases declined slightly, on average, from 146 per week in 1972 to 142 this year. Gross sales of these banks averaged $2.4 billion this year, up $650 million from the 1972 average. The average number of sellers rose from 716 to 750 per week—more than three-fourths of all member banks in this district. Thus, while some smaller banks do buy funds, at least occasionally, a far larger number are sellers.

A question might be raised as to the extent to which small banks may be channeling loanable funds to larger banks through this market, at the high fed funds rate now prevailing, in preference to meeting local loan demands. Available statistics on the distribution of bank assets cannot provide an answer to this question in the absence of a measure of loan demand. District member banks other than the 55 large weekly reporters (thus excluding most banks with deposits of $100 million or more) reported fed funds sales so far in 1973 about $200 million, or 19 percent, higher than in 1972. Other loans at these banks are up about $1.1 billion this year, although federal funds sold have increased slightly—from 7.2 percent in December to 7.5 percent in June—relative to total loans. Total investments of these banks have risen only slightly, with holdings of U. S. Governments down almost $300 million. These data suggest that while the fed funds market provides an attractive alternative for liquid securities, it has by no means usurped the rightful place of the loan customer at most small banks.