an economic review by the Federal Reserve Bank of Chicago

Business Conditions

The federal debt and commercial banks

Holding company developments in Michigan

october 1975

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Contents

The federal debt and commercial banks 3

Private credit demands are likely to increase in the near future and that raises questions as to whether banks will absorb as large a portion of new Treasury issues as they did in the first half and whether further bank financing of the federal debt will be inflationary.

Holding company developments in Michigan 10

A dramatic increase in the number and size of bank holding companies in Michigan since 1971 has had little impact on banking concentration either at the state or local market level.

Subscriptions to *Business Conditions* are available to the public free of charge. For information concerning bulk mailings, address inquiries to Research Department, Federal Reserve Bank of Chicago, P. O. Box 834, Chicago, Illinois 60690.

Articles may be reprinted provided source is credited. Please provide the bank's Research Department with a copy of any material in which an article is reprinted.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The federal debt and commercial banks

According to current projections the U.S. Treasury will raise in excess of $100 billion in net new cash through the issuance of public debt securities in the two fiscal years ending in June 1976. The amount is unprecedented in the post-World War II era. It totals more than twice the previous record registered for two fiscal years (1971-72). Two factors account for this extraordinary increase in the public debt. First, recession-induced declines in personal income and corporate profits reduced federal tax revenues. Second, an expansionary fiscal policy adopted to stimulate economic recovery, incorporating increased federal expenditures and tax cuts, has raised the deficit.

In the first half of 1975 interest-bearing marketable public debt increased by almost $33 billion, in contrast to about a $4 billion decrease in the first half of 1974. The Treasury was able to place a large portion of this contraseasonal increase in its debt with commercial banks—$14 billion or 42 percent—without putting severe upward pressures on interest rates because of greatly reduced private demands for credit. With economic recovery under way and private credit demands likely to increase in the near future, there is some question whether banks will continue to absorb a large portion of the new issues and growing concern about whether further bank financing will be inflationary.

The amount of marketable Treasury issues—bills, notes, and bonds—that might have to be placed with banks will depend, to a large degree, on the demand for Government securities by certain other investor groups in relation to the federal government's overall financing needs. The most important of these investor groups are individuals, foreigners, and the Federal Reserve System. Together, their net acquisitions of Government securities in the 1964-74 period ($100 billion) exceeded the total increase in the public debt over the same period ($92 billion, excluding amounts held by U.S. Government agencies and trust funds). At the end of last year individual holdings of public debt securities amounted to $85 billion, the largest share held by any private investor group. Of this total, $63 billion—or almost 75 percent—was in the form of nonmarketable savings bonds. The demand for savings bonds has shown a relatively stable upward secular trend in line with generally rising personal wealth in the post-World War II era. Given that the economy is in a recovery phase of the business cycle, it can be expected that individuals will continue to add to their holdings of savings bonds.

Foreign investors, primarily central banks and governments, began to make significant additions to their holdings of U.S. Government securities in the early seventies when foreign monetary authorities stepped up their exchange rate support activities and desired an investment outlet for the resulting increase in their U.S. dollar holdings. More recently, huge increases in the price of oil have led some petroleum-exporting nations to invest some of their swollen oil revenues in U.S. Government securities temporarily.

At the end of 1974 foreign holdings of the U.S. public debt totaled $58 billion, of which $23 billion was in the form of special

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

nonmarketable issues. With the advent of floating exchange rates and with oil-exporting nations beginning to divert greater portions of their revenues to domestic development projects, the demand for U.S. Government securities by foreign official holders may begin to wane.

The Federal Reserve System, with holdings of about $80 billion of Governments at year-end 1974, represents another important source of demand for the public debt. Since System open market purchases of Government securities provide a reserve base upon which money and credit can grow, the Federal Reserve will be adding to its portfolio of Governments to the extent consistent with an orderly expansion in economic activity.

Commercial banks as investors

Banks have not been heavy buyers of U.S. Government securities since World War II. There are fewer Government securities in commercial bank portfolios now than there were 30 years ago despite a fourfold expansion in total bank assets. The Treasury Department's survey of ownership of the public debt indicates that bank holdings of federal debt soared from $21 billion to $94 billion during World War II and the immediate postwar period but dropped sharply thereafter as government deficits declined and growth in the private economy and attendant credit demands resumed. During the past 25 years bank holdings have fluctuated within a range of $50 billion to $70 billion and at the end of last year stood at $56 billion. This was about 11 percent of the total public debt outstanding and 21 percent of that portion publicly held, that is, outside U.S. Government agencies and trust funds and Federal Reserve banks. But Government securities comprised only about 6 percent of the assets of commercial banks. Acquisitions in recent months have raised these holdings to the highest level since 1947, while total assets have declined, thus increasing the importance of U.S.

Composition and ownership of the public debt

	Outstanding 12/31/74	Change Ist half 1975
	(billion dollars)	
Marketable issues:		
U.S. Treasury bills	119.8	+ 8.8
U.S. Treasury notes	129.8	+20.5
U.S. Treasury bonds	33.4	+ 3.4
Total marketable	282.9*	+32.7
Nonmarketable issues:		
Savings bonds	63.4	+ 2.1
Government account series	119.1	+ 5.1
Foreign government series	22.8	+ 0.4
Other interest bearing	3.4	+ 0.2
Total nonmarketable	208.7	+ 7.8
Matured and noninterest-bearing issues	1.1	—
Total public debt	492.7	+40.5

	Outstanding 12/31/74	Change Ist half 1975
	(billion dollars)	
Estimated ownership:		
U.S. Government accounts	141.2	+ 4.1
Federal Reserve banks	80.5	+ 4.3
Private investors-total	271.0*	+32.2
Individuals	*84.8*	*+ 2.3*
Foreigners	*58.4*	*+ 7.6*
Commercial banks	*55.6*	*+13.6*
State and local governments	*29.2*	*+ 0.4*
Nonfinancial corporations	*11.0*	*+ 2.2*
Insurance companies	*6.2*	*+ 0.9*
Mutual savings banks	*2.5*	*+ 1.0*
All others	*23.2*	*+ 4.2*
Total	492.7	+40.5*

*Totals do not add due to rounding.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Governments in bank portfolios.

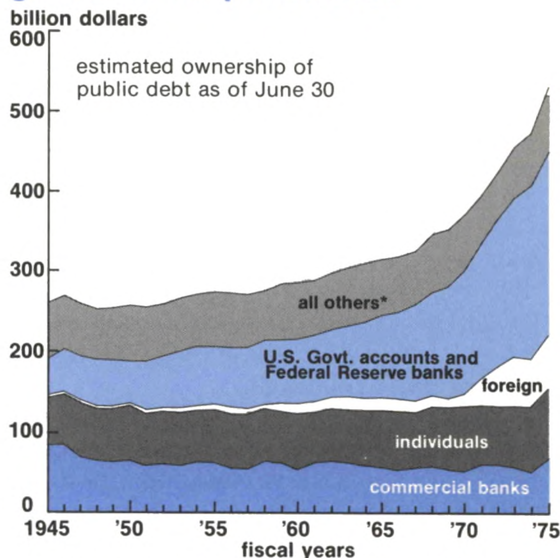
Bank holdings of Government securities are mostly marketable issues and are concentrated in the short-term maturity area. At the end of 1974 almost 90 percent of the Governments in bank portfolios matured in less than five years and 35 percent matured within one year. Banks prefer short-term assets in line with the relatively short maturities of their liabilities. In addition, short maturities are generally desirable with respect to the functions these securities serve in bank portfolios. Why do banks buy and/or hold U.S. Government securities and what factors determine the quantity they want to hold?

Liquidity. There is a broad and well-developed trading market in Government securities through which individual banks can adjust their cash positions in response to temporary deposit inflows and outflows. If a bank experiences a temporary cash inflow, or one for which it has no preferred "permanent" investment opportunity at the moment, the purchase of Government securities is one outlet for these funds that can be expected to contribute to earnings. Conversely, a bank can sell Governments quickly to meet an unexpected cash outflow or take advantage of a higher-yielding investment opportunity. The development of the federal funds market and increased reliance on liability management in recent years have diminished the importance of Government securities as a short-term cash adjustment vehicle. However, these securities do represent assets that can be turned into cash quickly. The ratio of short-term Governments to liabilities is a widely used measure of bank liquidity. This ratio usually declines in periods of heavy loan demand, such as 1973-74. Acquisitions of Governments in the first half of this year have gone a long way toward restoring the liquidity ratio to more desirable levels.

Solvency. The gilt-edged quality of Treasury securities contributes to the financial soundness of the commercial banking system. During periods when the possibilities of loan defaults increase, Government securities serve to cushion a decline in the value of other assets. Given the rapid expansion of loans in the portfolios of banks compared to the relatively slow growth in capital positions during the last decade, the solvency factor associated with Government securities may take on added importance in the planning strategies of banks in the years ahead.

Collateral. Their near-universal acceptability and efficient trading market make Government securities ideal collateral. Typically, member banks pledge Governments against their borrowings from the Federal Reserve System. The law requires that commercial banks collateralize the full amount of their U.S. Treasury demand deposits (less the $40,000 insured by the FDIC) by means of U.S. Government securities, federal agen-

Commercial banks have not financed the post-World War II growth in the public debt



*Includes other financial intermediaries, nonfinancial corporations, state and local governments, nonprofit institutions, dealers and brokers, and certain government accounts.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

cy securities, state or municipal securities, or certain other specified assets. Banks must pledge similar securities for most state and local government deposits.

Income. Obviously, U.S. Government securities are a source of income to banks, although, because of the risk factor, their nominal yield is less than that on most other earning assets. Banks tend to increase their holdings of Government securities in recessionary periods and decrease their holdings in expansionary phases of the business cycle. In periods of economic recession, loan demand at banks moderates, whereas funds available for lending are relatively plentiful. This tends to narrow and at times eliminate the differential between returns on loans and yields on Government securities, especially when the cost of managing loans is taken into account. This pattern tends to lag the cycle somewhat, as do credit demand and interest rates. In the latest recession banks did not begin to acquire large amounts of Treasury securities until March 1975, when the federal funds rate dropped below the Treasury bill rate. At this point banks were able to hold even short-term Governments at a positive carry, i.e., at a cost of funds below the yield on securities.

The willingness of banks to buy and hold securities is also influenced by their expectations about the direction of interest rates, and therefore the market value of those securities, in the period following the purchase. Buying for capital gains, or speculation, is usually a short-run matter and does not have much effect on the trend levels of bank holdings.

Underwriting. Besides purchases for their own investment accounts, many banks serve as underwriters for Treasury securities—as do nonbank Government securities dealers—distributing new issues to their customers in line with their investment needs. Most smaller banks would serve their customers as brokers in such situations. But larger banks actually hold trading portfolios of these securities apart from their investment accounts and stand ready to buy and sell them at prices that reflect current yield trends. Any net trading profits are also a source of income. Banks, in the aggregate, usually receive the largest allotments of Treasury offerings of marketable securities. This reflects both the large amount of Government securities in their investment accounts and their underwriting role. Evidence of this underwriting role is revealed by the fact that in 1973 banks were allotted $9.3 billion, or 63 percent, of the $14.8 billion of Treasury coupon securities offered to the public, yet the net year-to-year change in their holdings of coupon issues declined by $4.3 billion.

Bank financing and inflation

Concern about the inflationary potential of commercial banks financing the federal deficit is based on two factors. First, the acquisitions of new Treasury debt by banks may increase the money supply, i.e., federal deficits may be "monetized." Second, Government securities acquired during periods of economic decline create a reservoir of liquidity in the banking system that can lead to the overexpansion of loans as economic activity and private credit demands increase.

How do bank purchases of U.S. Government securities create money? Just as banks credit borrowers' deposit accounts when they extend loans, banks may credit the sellers' deposit accounts when the banks buy securities. When a bank purchases Government securities in a Treasury offering, bank assets increase by the amount of the securities purchased. The Treasury maintains deposits with most commercial banks (Treasury tax and loan accounts, so-called TT&L accounts). In some offerings payment is permitted through credits to these TT&L accounts.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

When the Treasury uses the proceeds of its securities' sales to make payments to businesses and individuals, privately held demand deposits, which constitute the major part of the money supply, increase. Thus, an increase in banks' holdings of Government securities can lead to an increase in the money supply just as expansions of banks' loan portfolios do.

However, whether this process results in a net growth in the money supply depends on the level of excess reserves[1] in the banking system and the reserve-supplying operations of the Federal Reserve System. If a higher level of deposits is to be maintained, the reserves must be available to support it. If banks hold no excess reserves, then *net* additions to their asset holdings financed via the creation of new deposits cannot be sustained unless the Federal Reserve System supplies the additional reserves required. In the absence of this reserve growth the banking system can add to its holdings of Government securities only by reducing its holdings of other assets. In the first eight months of this year loans declined by more than the rise in U.S. debt on the banks' books, and bank reserves also declined.

The substitution of Government securities for loans over this period largely reflects falling loan demand as business customers liquidated inventories and sold corporate securities to pay down bank loans. In addition, banks were anxious to rebuild liquidity and many were willing to see their total assets and deposits shrink to a lower multiple of bank capital.

When private credit demands are rising, the return on Government securities has to rise in order to induce banks to increase their holdings in the absence of reserve expansion. Increases in yields on Governments lead to increases in rates on competing instruments and other bank-held assets. At these higher interest rates some private investment projects become too costly in relation to expected returns, and the quantity of private credit demanded declines. In this scenario government borrowing may replace, or "crowd out," a certain amount of private borrowing.

However, if the Federal Reserve System supplies additional reserves, banks *can* expand their portfolios of Government securities without reducing holdings of other earning assets. Deposits rise because of banks' acquisitions of Treasury securities. Thus, that portion of the federal deficit financed through the banking system can be said to be monetized. But whether that process is inflationary depends on whether the overall money growth is excessive.

The Federal Reserve System monetizes private debt whenever it supplies reserves necessary to support increased deposit levels resulting from an expansion of bank loans to private borrowers. If loans are not growing, there will be no monetary expansion from that source. The real issue with regard to inflation is not whether debt—public or private—gets monetized, but whether too much of it does. The special concern in the case of large federal deficits is that in assuring the success of Treasury financings, the central bank will purchase too much outstanding debt—providing a base for monetary expansion greater than that which is consistent with balanced economic growth.

How much will the cushion of liquidity represented by banks' portfolios of Treasuries insulate them from the impact of monetary restraint and thus contribute to an inflationary rate of expansion in the next economic upturn? Unless the public debt is declining, the sale of Government securities by banks (or the failure to rollover maturing issues) to finance loan

[1]Banks that are members of the Federal Reserve System must maintain either vault cash or balances at their Federal Reserve banks or, most commonly, some combination of the two, at a level equal to a prescribed percentage of their deposits. The difference between actual reserves held and the reserves required by deposit levels are "excess."

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

growth implies net acquisitions of Governments by the nonbank public—mainly individuals, businesses, foreigners, and local governments. To induce nonbank investors to hold a greater amount of Government securities, yields on these securities have to rise, putting upward pressure on other interest rates as well. To the extent that private expenditures are sensitive to interest rates and to the degree to which the monetary authorities are willing to let interest rates rise, some consumption and investment spending would be curbed, reducing the inflationary potential. Another limiting factor in this process is the reluctance of banks to incur capital losses associated with the sale of securities in a period of rising interest rates. Such liquidation is greatly facilitated, however, if the securities are short term.

Problems of shortened maturity

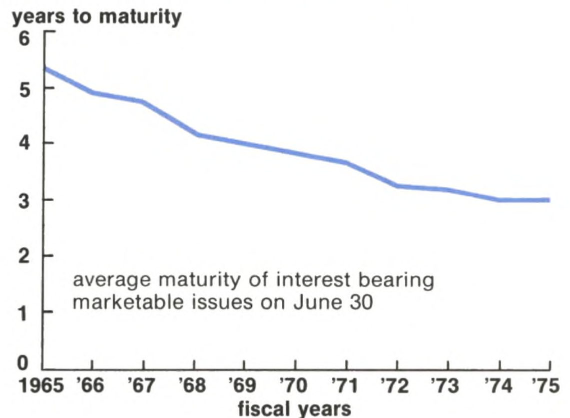
In the last ten years the average time to maturity of all marketable U.S. Government securities declined from five years to three years. Some experts believe that an ever-shortening maturity structure in the public debt tends to build a permanent inflationary bias into the economy. In this view, as short-term Government securities increase relative to long-term securities, private holders of the public debt are more liquid and are inclined to step up their rate of spending. Furthermore, because of the usually smaller price variations associated with short-term debt in comparison to long-term, the "locking-in effects"—capital loss constraints on bank liquidations of securities to meet expanding loan demand—are reduced as the proportion of short-term securities in bank portfolios increases.

Because banks have been in a position to purchase a large portion of the increase in Government securities since the beginning of this year, Treasury debt managers have tailored the maturity of offerings of U.S. Governments to conform with the preferences of banks. Since bank portfolios of Governments are largely concentrated in maturities of two years or less, the heavy reliance on banks in absorbing the new issues has not permitted significant debt lengthening. Nevertheless, some slight extension was accomplished despite the huge volume of financing involved.

Another obstacle to lengthening the federal debt, not just recently but in the last ten years, has been the statutory 4¼ percent maximum on the coupon rate for Treasury bonds. Since the mid-1960s market yields on long-term Treasury issues have risen above this ceiling by an increasing margin—effectively preventing the sale of new bonds. Some relief from this constraint was obtained in 1967 when Congress extended the maturity definition of Treasury notes from five years to seven years.[2] Additional legislation was enacted in 1971 exempting up to $10 billion of outstanding Treasury bonds from the 4¼ percent coupon rate ceiling and was amended in 1973 so as to apply the entire $10 billion exemption to *publicly held* Treasury bonds. Currently, the Treasury has about a $1 billion leeway under this exemption.

[2]There is no coupon rate ceiling on notes.

The average maturity of outstanding marketable public debt has shortened steadily



Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The shorter the average maturity of the public debt, the more frequently the Treasury must enter the market in order to refinance it. For example, in 20 of the next 24 months beginning October 1, 1975, significant amounts of either Treasury coupon issues or special bills will mature. It is likely that the Treasury will also enter the market to raise new cash through these types of issues in some of the four remaining "open" months.

During periods when the Treasury is offering coupon issues or is selling a large amount of bills in a special auction, the Federal Reserve often follows what has been termed an "even-keel" policy, that is to say, the Federal Reserve System usually takes no overt actions that would affect investors' near-term expectations of interest-rate behavior. The purpose of even-keel policy is *not* to enable the Treasury to place its debt at artificially low interest rates, but rather to remove one element of uncertainty—namely movements in interest rates resulting from unanticipated monetary policy actions—from a market that may be somewhat more "sensitive" due to the relatively large amounts of new issues that it is being asked to absorb over short periods of time.

The main problem imposed by the even-keel constraint is that countercyclical policy action may be delayed because of a Treasury offering. Since an even-keel policy is maintained for only a couple of weeks at a time, a delay in the implementation of either a more restrictive or more accommodative monetary policy for this period of time would not seem to be an undue constraint. Furthermore, the Treasury's adoption of the auction technique in coupon offerings in recent years has eliminated part of the need for even-keel policy and has diminished the average length of even-keel periods. Nevertheless, the more often the Treasury comes to the market with major financings, the fewer "free" periods the Federal Reserve has to make policy changes. This could either necessitate more intensive or abrupt monetary policy actions in periods between Treasury financings—thus generating wider fluctuations in short-term interest rates—or curtail the System's ability to control credit and monetary expansion.

Despite the nearly $19 billion of federal debt acquired by the commercial banks and the $1 billion net purchased by Federal Reserve banks in the first eight months of 1975, the moderate growth in deposits and the slight decline in the reserve base of the banking system indicate that bank financing of the deficit did not fuel inflation during that period. However, with a substantial amount of Government securities still to be sold in an environment where the economic recovery will be generating increased private credit demands, the inflationary potential of bank absorption is greatly increased.

Paul L. Kasriel

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Holding company developments in Michigan

In April 1971 the Michigan legislature repealed a 40-year-old statute prohibiting Michigan corporations from owning bank stock. In the wake of repeal the state's banking structure has changed dramatically. From June 1971, when the Board of Governors of the Federal Reserve System approved the first application by a Michigan corporation to organize a bank holding company, through August 1975, the formation of 36 holding companies was approved. These holding companies were granted authority to acquire 109 banks—about 30 percent of all commercial banks in the state—with total deposits of $20.7 billion, or 74 percent of commercial bank deposits in Michigan.[1]

A look beyond these numbers reveals that the change in Michigan's banking structure to date has been almost exclusively one of form rather than substance. The dramatic growth in bank deposits controlled by holding companies really represents the corporate reorganization of Michigan's largest banks plus the banks with which they were historically affiliated into the holding company form. Less than 7 percent of all holding company deposits can be accounted for by either acquisitions of previously independent banks or the establishment of new banks. As a result, the growth in the number and size of bank holding companies has had little impact on the concentration of banking resources at either the state or local market level. (See *Business Conditions*, June 1975.)

[1]Unless otherwise specified, numbers of holding companies and subsidiaries are based on approvals granted through August 31, 1975; deposit data reflecting these approvals are for December 31, 1974.

The new holding companies

The state statute that prohibited corporate ownership of bank stock did not preclude bank holding company activity (partnerships and trusts could hold bank stock), but it did effectively relegate holding companies to a position of insignificance in Michigan's banking structure. There were 27 companies that controlled Michigan banks prior to the repeal of the prohibition, but none of these has been a factor in the dramatic bank holding company expansion that has taken place since 1971. Indeed, roughly two-thirds of these companies are no longer active as bank holding companies.

In sharp contrast, two-thirds of the bank holding companies established in Michigan since 1971 either have been or currently are involved in acquisitions of additional banks. Six of the 36 bank holding companies formed since 1971 were established as multibank organizations, and each has since acquired at least one bank not affiliated with it at the time of its formation. Fifteen of the companies were formed as one-bank entities and have evolved into multibanks; another one-bank holding company has applied to convert to multibank status, and two others were granted such authority but did not consummate their planned acquisitions.[2]

The profile of the "typical" bank holding company established in Michigan since 1971 distinguishes it on all counts

[2]Two of these 36 new companies have since divested: one through merger with another holding company and the other as a result of a corporate reorganization.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

from those holding companies operating prior to the statutory change. The typical new company:

- functions as a permanent entity established at the initiative of the management of its lead bank;
- owns almost all of the outstanding stock of its subsidiary bank(s);
- controls a bank ranking among the largest 50 in the state;
- and has made acquisitions that may include nonbank firms since its formation.

In contrast, the pre-1971 holding company:

- was established by shareholders—rather than management—as a temporary reservoir for their bank shares;
- generally owned little more than a simple majority of the shares of the subsidiary bank(s);
- controlled a lead bank whose deposits were less than $50 million;
- did not seek to expand into new banking markets or activities.

In short, holding companies formed prior to 1971 served strictly to facilitate ownership and had little impact on the operation of the subsidiary bank; holding companies formed subsequent to 1971 represent an important management tool adopted explicitly to play a strategic role in the conduct and future development of their banking business.

Expansion and statewide concentration

The proliferation of multibank holding companies since 1971 has been the most notable alteration in the banking structure of Michigan. By and large, the one-bank holding company has represented merely an interim stage in the conversion to multibank status. Relatively little utilization of the holding company as a vehicle for diversification into permissible nonbanking activities has taken place.

Since repeal of the statute, 21 multibank holding companies have been formed in Michigan; these companies control 96 banks accounting for 63 percent of the deposits in the state. Seven of the ten largest banks in Michigan—and 16 of the 25 largest—are affiliates of multibank holding companies. One could reasonably expect that aggregate concentration—or the cumulative share of the state's banking resources accounted for by its largest organizations—would have increased substantially, but the facts do not support this hypothesis. At the end of 1970 the ten largest banks in Michigan controlled 57.7 percent of the state's deposits. Based on approvals through August 1975, the share of state deposits accounted for by the banking organizations controlling these same ten banks (still the ten largest) was precisely the same, even though these holding companies controlled a total of 43 banks.

What would appear to represent the one change having significance for aggregate concentration during the period of intense multibank holding company formations, namely the combination of the state's fourth and sixth largest banks into the state's second largest banking organization, does not in fact represent any meaningful change. For a number of years these banks had operated as members of a banking group unified through common directors and interchangeable management. Their acquisition by a single corporate entity merely formalized an existing relationship.

The failure of multibank holding company expansion in Michigan to lead to an increase in statewide concentration can be explained by the very size of the large Michigan banks. No bank outside the ten largest accounted for more than 2 percent of the state's deposits. Therefore, few acquisition candidates existed that would immediately increase the deposit shares of the state's leading banking organizations to any noticeable degree. More importantly, managements of Michigan's largest

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Michigan one-bank holding company deposits rose sharply and then declined . .

	One-bank holding companies (OBHCs)				
	OBHCs	Subsidiary banks	Total OBHC deposits	Share of state deposits	Share of total banks
	(number)		*(million dollars)*	*(percent)*	
1970	25	17	$ 624	3.0	5.1
1971	27	19	917	4.0	5.7
1972	25	21	2,216	8.7	6.3
1973	31	27	12,575	46.7	7.9
1974	26	23	3,527	12.5	6.6
1975	22	21	3,458	12.3	6.1

NOTE: Data for 1970 through 1974 represent actual requisitions and deposits as of December 31. Data for 1975 are based on approvals through August 31, 1975 and deposits as of December 31, 1974.

bank holding companies apparently assumed that proposals to make significant acquisitions probably would be denied by the Board of Governors of the Federal Reserve System. Such suspicions were confirmed in early 1974 when the Board denied an application by Old Kent Financial Corporation, Michigan's sixth largest banking organization, to acquire the state's sixteenth largest organization, Century Financial Corporation.[3]

Shaping the banking structure

Two Michigan holding company decisions—one a denial and one an approval—put holding companies on notice that the Board of Governors would consider a proposal's potential impact on the banking structure of the state as well as its potential impact on competition at the local market level. In the Old Kent-Century Financial decision the Board based its denial first of all on the acquisition's substantial adverse effect on potential competition in the Saginaw banking market, a highly concentrated local market in which the bank to be acquired was by far the largest competitor.[4] The order went on to explain that "The Board is also concerned with the effect that consummation of this proposed merger would have in eliminating Century Financial as a large independent which, whenever its management becomes so inclined, would seem capable of anchoring a regional holding company system."[5]

The Old Kent-Century Financial decision did not imply, however, that the Board desired to preserve each and every independent that might be capable of anchoring a holding company system. The Board has been as concerned with the *relative* strengths of the state's emerging banking organizations as it has with their number. In this context, the Board approved the application of American Bankcorp, Inc., a multibank holding com-

[3]1973 *Federal Reserve Bulletin* 301.

[4]The "potential competition" concept applied by the Board in this case referred to the elimination of important probable future competition. See *Business Conditions*, April 1975 for a discussion of the Board's application of the potential competition doctrine.

[5]It should be noted that the Board's judgment has since been verified as Century Financial has applied to establish a de novo bank subsidiary in an adjacent market.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

. . . as the largest companies converted to multibank organizations.

	Multibank holding companies (MBHCs)				
	MBHCs	Subsidiary banks	Total MBHC deposits	Share of state deposits	Share of total banks
	(number)		(million dollars)	(percent)	
1970	2	5	$ 568	2.7	1.5
1971	1	2	540	2.3	0.6
1972	4	11	3,436	13.5	3.3
1973	11	44	5,690	21.1	12.9
1974	19	78	16,563	58.9	22.5
1975	22	96	17,670	62.9	25.9

pany based in Lansing and ranked as the seventeenth largest banking organization in the state, to merge with the state's twentieth largest banking organization, whose sole subsidiary was the largest bank in the nearby Ann Arbor market.[6] Upon acquisition, American Bankcorp became Michigan's eleventh largest banking organization. In its order the Board stated that ". . . the present proposal should have an overall positive effect on competition in the state in the future by creating a stronger banking competitor that would be capable of competing with the largest banking organizations in Michigan."

The fact that the state's largest organizations had been able to maintain, although not increase, their share of the state's deposits only by expanding their holding companies was a matter of concern to the Board. Moreover, the emergence of four holding companies with over $2 billion in deposits (two and a half times larger than the next largest organization) had led to greater disparity in size among the state's leading organizations. The American Bankcorp decision can be viewed as an attempt to reverse this trend.

[6]40 *Federal Register* 14374, March 31, 1975.

Expansion and local markets

While statewide concentration of banking resources is an important element in shaping the overall environment in which banks compete, the structure of local markets largely determines the degree of competition among banks. The extent to which holding company expansion ultimately enhances or stifles competition within a state's local markets will depend largely upon the pattern that such expansion follows. Economic theory suggests that if bank holding companies were to charter new banks in markets in which they were not previously represented, the impact almost certainly would be procompetitive. At the opposite extreme, if holding companies were to acquire existing banks within their present markets, the net effect of a series of such acquisitions likely would be anticompetitive.

The vast majority of Michigan bank holding company expansions have fallen into neither of these categories: as a result, the ultimate impact of multibank holding company expansion on competition within Michigan's local markets remains unclear. Most holding company acquisitions in

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Michigan (other than the acquisition of a prior affiliate of the lead bank) have involved either the chartering of a de novo bank subsidiary within the market(s) already served by the holding company or the acquisition of existing banks to accomplish entry into new markets. In neither of these situations is the transaction immediately accompanied by a change in local market structure (generally measured by the distribution of market shares among competing organizations). Consequently, a judgment regarding the competitive impact of holding company expansion in Michigan is neither obvious nor can it fairly be rendered without the passage of a longer period of time.

De novo expansion

While intramarket chartering of de novo bank subsidiaries, especially by the largest organizations in a market, could ultimately (but not necessarily) lead to increased market concentration, the establishment of new banks inevitably serves to increase banking convenience for the public. Holding company expansion in Michigan has clearly produced this beneficial effect. Michigan bank holding companies have chartered 21 new banks within the past two years; during the previous eight years, a total of only 13 new banks were chartered in the state.

Moreover, in a state such as Michigan, where banks operate under rather restrictive branching laws, the chartering of new banks, even by a market's largest organizations, can lead to increased competition. Michigan law restricts bank branching to the home county or within a radius of 25 miles from the home office. More importantly, banks are prohibited from establishing a branch in incorporated areas, other than their home community, already served by any banking office. The net effect of Michigan's branching law is to confer upon some banks what could be regarded as limited local monopolies.

For example, a bank located in a suburb that is actually only a small portion of a much broader geographic banking market, such as a metropolitan area, must be subject to at least some competitive influences from other banks in the market. Nevertheless, such a bank could enjoy considerable latitude in determining the prices and the services it offers, especially with respect to the prices paid and services used by customers with limited mobility, provided that other banks within the market are legally precluded from entering that suburb. In such situations, entry by holding companies through their new capacity to charter de novo banks would immediately erode whatever monopoly power the suburban bank had enjoyed.[7]

To the extent that multibank holding companies in Michigan have increased the rate of actual entry into their own markets by establishing new banks, or even expressed an interest in entering those sections of the market where they were not already represented, the transmission of competitive forces and therefore competition itself has been enhanced despite the potential for increased concentration.[8] This outcome appears to have been an objective of Michigan's legislators in adopting the 1971 statutory change. What is disappointing about the multibank movement in Michigan is the relatively few instances of *inter*market chartering of new banks by holding companies. Such entry into new markets by holding companies

[7]Such de novo entry can in fact be regarded as a form (albeit an expensive form) of de facto branching since it is likely that holding companies, were it permissible under state law, would have chosen to establish branches of their subsidiary banks at the same locations where they have chartered new banks.

[8]Actual entry is not a necessary prerequisite for increased competition in a section of a market where the incumbent bank(s) enjoys a limited monopoly position. As long as the incumbent bank(s) perceives an increased *threat* of entry into its service area by a multibank holding company not located there, its behavior is likely to become more competitive.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

would bring the identical competitive benefits without any possibility of concommitant increases in market concentration.

The performance of Michigan's largest organizations, those with over $2 billion in deposits (therefore, those probably most capable of successfully entering new markets on a de novo basis) has been the most disappointing aspect of this trend. It was not until September 1975 that one of the "big four" chartered a de novo bank in a new market. Prior to that time, these companies had chartered eight de novo subsidiaries, all within markets they previously served. Surprisingly, of the six banks established in new markets by Michigan's multibank holding companies prior to September 1975, half were chartered by organizations with total deposits of less than $125 million.

Expansion via acquisition

While it is true that Michigan's multibank holding companies have tended to enter new markets by acquiring existing banks, where practical (in metropolitan markets) they have accomplished such entries through acquisitions that approximated the functional equivalent of de novo entry. Of 34 entries into new markets by acquisitions of existing banks, 12 took place in metropolitan banking markets.[9] Of these, eight represented the acquisition of a bank accounting for less than 5 percent of total market deposits and/or was the smallest bank in the market at the time of acquisition. As the Board often notes in its orders, such "foothold" acquisitions are equivalent to de novo entry since they tend to have a salutary effect on competition.

Of the remaining four acquisitions in new metropolitan markets, only that by American Bankcorp in Ann Arbor involved a bank whose share of local market deposits exceeded 20 percent. The only other attempts to acquire metropolitan area banks of this size were denied by the Board—the Old Kent-Century Financial application discussed above and another proposed acquisition by Old Kent—that of the second largest bank with 24 percent of deposits in the adjacent Muskegon market.[10]

Entry into non-metropolitan and rural areas of Michigan has tended to be accomplished through acquisitions of larger, well-established banks. De novo entry into such areas may be unattractive and foothold entry is often impossible. Where competitors tend to be few in number, the market share (though not the absolute size) of each tends to be significant. In these situations, entry by outside organizations, even through the acquisition of a major market participant, could possibly serve to stimulate competition.

Outlook for the future

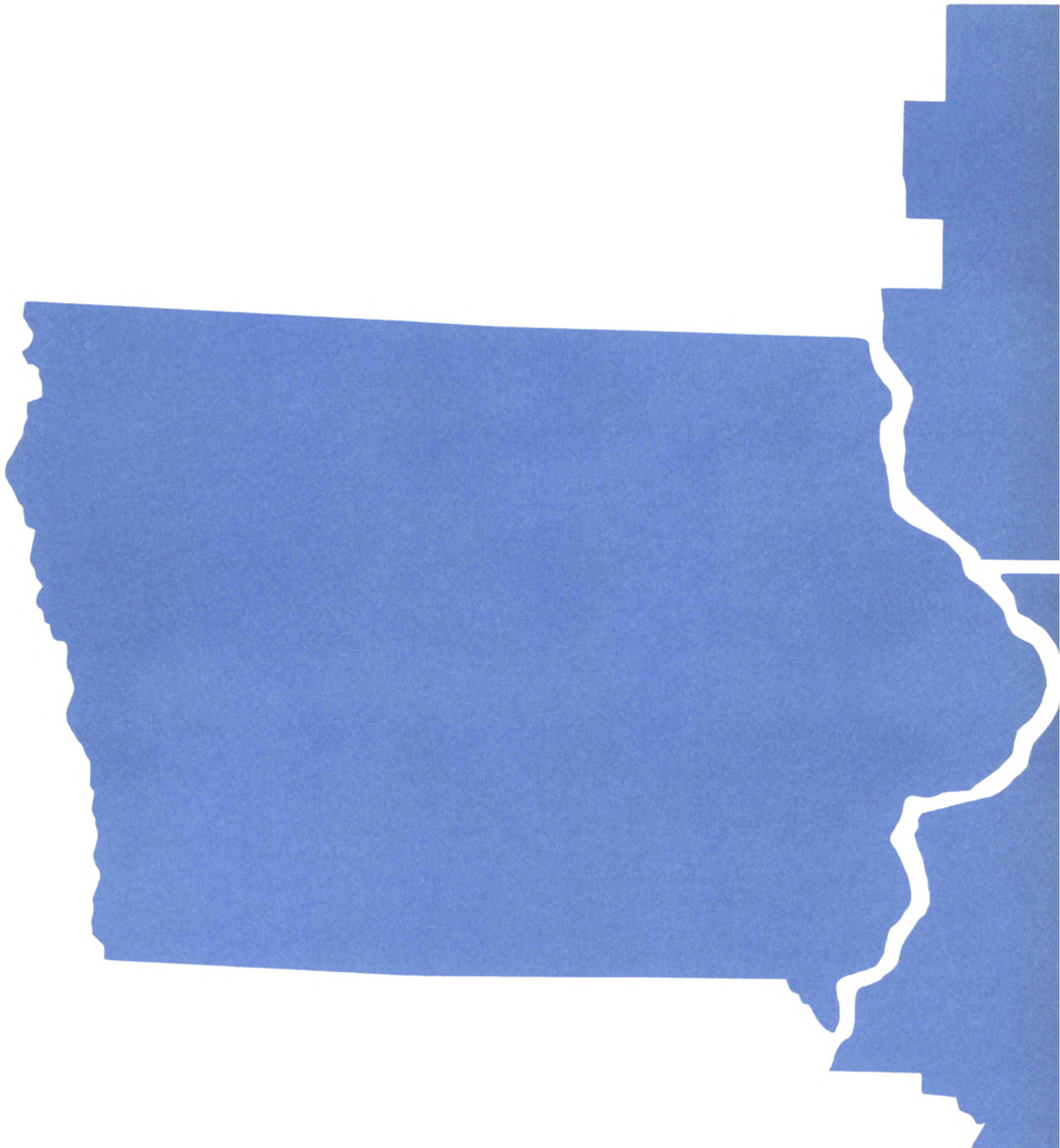
Based on past events, continued expansion of Michigan's multibank holding companies appears certain, and it is likely to be accompanied by further consolidations of existing organizations as well as the emergence of new ones. While the pattern that expansion has followed thus far could eventually result in increased concentration at both the state and local market level, it also holds the promise of more vigorous competition within Michigan's metropolitan and rural markets. It will continue to be the Board's role to guide the expansion so that this promise is fulfilled.

Nancy M. Goodman

[9]A metropolitan banking market is one which includes the central city of a Standard Metropolitan Statistical Area.

[10]These two denials (of only four issued by the Board in Michigan) are the only ones that were based upon competitive considerations.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis



Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis