

A BUSINESS AND FINANCIAL REVIEW BY THE FEDERAL RESERVE BANK OF CHICAGO

March/April 1977

ECONOMIC
PERSPECTIVES

Business insights
Banking insights
Nonbanking activities of
bank holding companies
State and local government
deposits in the district



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ECONOMIC PERSPECTIVES

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The growth of bank holding companies and their tendency to acquire nonbanking business enterprises raise numerous economic issues. These include permissible nonbanking activities, diversification, risk, soundness, concentration and competition, operating efficiency, and pricing and profitability—among the issues examined in this article.

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State and local government deposits are becoming increasingly important on the balance sheets of the Seventh District's—and the nation's—commercial banks.

Business insights

Employment and unemployment

Early each month, usually the first Friday, the United States Bureau of Labor Statistics (BLS) issues its report, "The Employment Situation." This publication presents a dozen statistical tables with estimates of total employment and unemployment, nationally, with appropriate breakdowns.

The news media typically give wide publicity to current estimates of changes in unemployment, but often omit mention of estimates of changes in *employment*. This practice distorts the overall intelligence provided by the data. Not infrequently, unemployment increases in months when employment also increases, and vice versa. The unemployed are not necessarily people who have "lost their jobs," but, rather, people without jobs who are "seeking work" for whatever reason. Rising job opportunities sometimes encourage potential workers to look for jobs. Until they find work or cease looking, they are classified as unemployed.

Big gain in employment

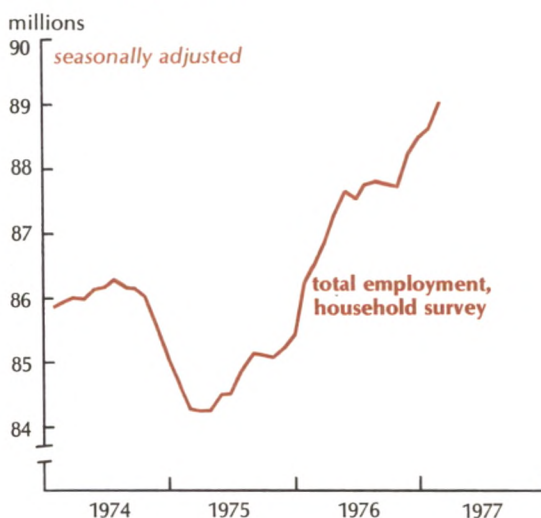
High levels of unemployment unquestionably reflect underutilized human resources, and often personal tragedy. But keeping the spotlight on unemployment has tended to obscure the substantial growth in output and employment that has occurred in the past two years.

In December, before the severe weather struck, 88.4 million Americans were employed in civilian jobs. (These figures allow for normal seasonal influences.) This was 3 million more than a year earlier, 2.2 million more than at the prerecession high in 1974, and 4.2 million more than at the recession low in the spring of 1975. Almost 41 percent of the entire population held civilian jobs in late

1976, a record proportion.

Despite the strong rise in employment in the past two years, unemployment is estimated to have totaled 7.5 million in December—7.8 percent of the civilian labor force, which includes both those working and those seeking work. Unemployment was almost as high as the average for 1975. The civilian labor force rose 3 percent last year, twice as fast as in 1975, and substantially more than most analysts had expected on the basis of historical experience. Reasons for the rapid rise in the labor force are not fully understood. Aside from the growth of job opportunities, other suggested reasons include a desire for supplementary income to offset inflation, and pressures on employers to hire people who had been considered unemployable in the past.

Sharp rise in employment since early 1975



Samples and surveys

BLS estimates of total employment and unemployment (the “household” series) are derived from interviews by the Bureau of the Census in its Current Population Survey. About 47,000 households, representing almost 150,000 individuals, are contacted each month. Respondents are asked a series of questions, relating to the week containing the 12th day of the month. Each individual is classified as employed, unemployed, or “not in the labor force.” Estimates are for the civilian noninstitutional population (inmates are excluded) 16 years and over.

Employed persons counted by the household series are those who worked full-time or part-time for pay, either as employees or proprietors or as unpaid workers in a family enterprise. The household series considers strikers to be employed.

The BLS also prepares a monthly estimate of nonagricultural payroll employment based on reports from employers (the “establishment” series). Payroll employment, also for the week including the 12th, excludes proprietors, domestics, and farm workers, but may count people twice if they hold two jobs.

The establishment series does not include strikers. Also, it provides no information on unemployment. Employment estimates for states and local areas are based on the establishment survey.

Both the household and establishment series include government as well as private workers. Neither includes the armed forces, which number 2.1 million currently.

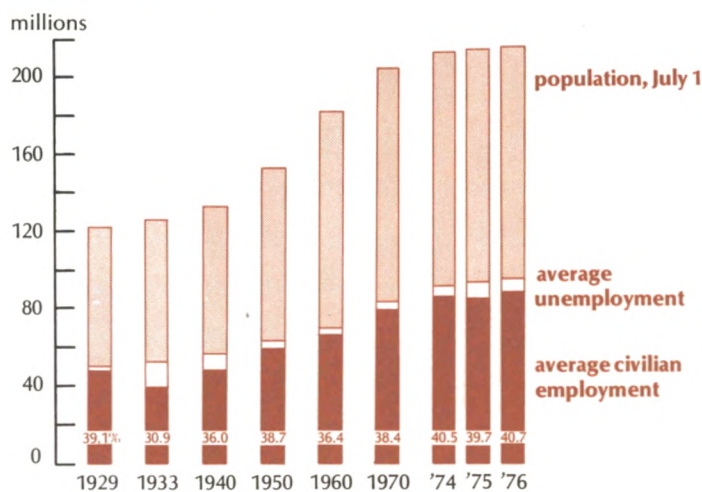
The household series counts people as unemployed if (1) they did not work at all in the survey week, and (2) they had searched for work in any of the preceding *four* weeks. The job search may take any form, e.g., asking relatives or

scanning want ads. Some job seekers, especially “secondary” workers who are not responsible for dependents, may have strict reservations as to the pay, hours, and type of work they will accept. No attempt is made to evaluate the degree of determination involved in seeking work. On the other hand, the unemployed do not include “discouraged” people who have decided a job search is fruitless.

Only about half of those counted as unemployed each month are “job losers.” The other half either (1) left their jobs voluntarily, (2) are first-time job seekers, or (3) have reentered the labor force after taking time out for school, child rearing, or other reasons.

Clearly, the concept of unemployment is less precise than the concept of employment. Definitions of unemployment have changed over time, thereby affecting historical comparisons. The social environment also has changed as unemployment compensation has been liberalized and extended, and welfare programs have been expanded. These benefits are supposed to be paid only if people able to work represent themselves as seeking suitable work. Increased home ownership, larger accumulated savings, and

Employment at new high relative to population



Note: Before 1950 employment and unemployment are for persons 14 and over.

broader use of severance pay also permit people to withhold their services from the job market if attractive jobs are unavailable. Finally, the rise in the proportion of the labor force represented by women, teen-agers, and minority groups in the past decade or so tends to increase total unemployment because these groups have higher unemployment rates than adult men.

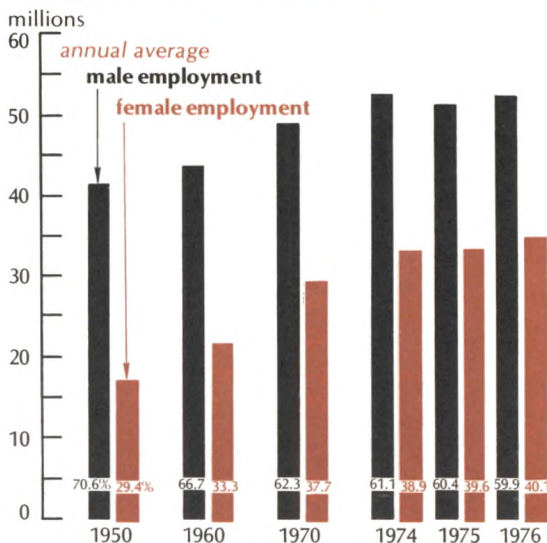
More women workers

In 1947, after many women had given up war-related jobs, women workers averaged 16 million, 28 percent of the total 57 million American workers. This proportion has increased almost every year. Last year, female employment averaged over 35 million, 40 percent of total employment, which averaged a record 87.5 million. As recently as 1965 the proportion of women workers was under 35 percent.

The absolute number of women workers has averaged higher each year since 1958. In this period the number of male workers averaged lower than in the previous year in 1961 and 1975. The contrast was particularly striking in 1975, when the average number of male workers declined 1.3 million, or 2.5 percent, while women workers increased 130,000, or 0.4 percent.

Although work performed by women in their own homes clearly has economic significance, housewives have never been counted in the labor force and their "product" is not counted in the gross national product. Increased use of household appliances and convenience foods has freed many women for paid jobs. Other women have sought work because of the rise in divorces and broken homes. A very important factor has been the decline in the birth rate from 25 per 1,000 population in 1957 to under 15 in the past five years. This has meant that a declining proportion of adult women have small children to care for. Along with these forces female employment has been increased by changes in social attitudes. Increasingly, jobholding by women has been viewed with esteem rather than opprobrium.

Women workers comprise rising share of work force



The growth of female employment also has been aided in recent years by court orders and regulatory decrees. Job upgrading for women has also been pushed. Nevertheless, earnings for women in full-time jobs average significantly less than for men, and a larger proportion of women are voluntary part-time workers. These factors tend to slow growth in average earnings and average hours as calculated for all workers.

Teen-agers

The problems young people encounter in getting and finding jobs is a matter of continuing concern. However, it should be kept in mind that relatively few teen-agers are the "primary" workers in a household or family. Although they may add significantly to total family income, much of their earnings is spent on their own education, automobiles, or other wants.

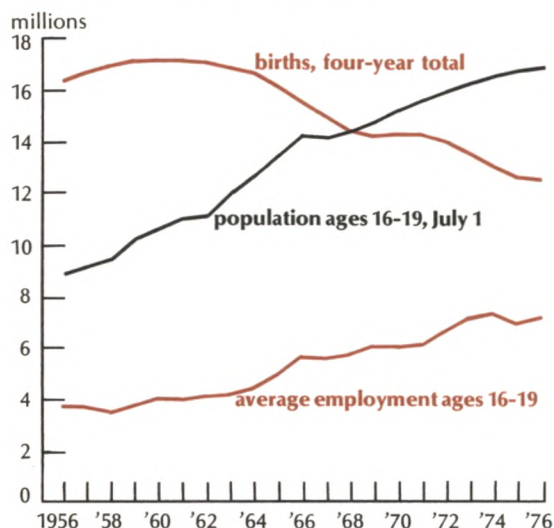
Unemployment rates for the 16-19 year age group have held close to 20 percent in recent years, while rates for both males and females aged 20 and over have been below the average for all workers. Unemployment among teen-agers tends to be high for a number of reasons: (1) the high birth rates of

the late 1950s have increased the supply of young workers relative to demand; (2) they often lack experience, skills, and proper work habits; (3) they have low seniority on full-time jobs; (4) their attachment to the job market is often sporadic; (5) personnel requirements of the armed forces which draw heavily on teen-agers are less than in earlier years; and (6) minimum wages, whether enforced by government or unions, tend to restrict opportunities for new workers.

In 1976 there were 17 million Americans aged 16 through 19. This is virtually the same as the number of births in the years 1957-60 when births were at an all-time high of 4.3 million per year. The number of births began to decline in 1962 and in recent years has averaged just over 3 million. In future years, therefore, the number of teen-agers will be declining while the total population continues to grow, partly through net immigration from abroad.

Only about 53 percent of the 16-19 age group is in the labor force, either employed or unemployed at a given time. Of 7.3 million teen-agers employed last year, on average, 46 percent held part-time jobs, compared to 14 percent for all workers. Of these, the great majority did not want full-time jobs, usually

Teen-age population and employment growth slow



because they were full-time students.

Teen-age workers have accounted for 8 percent of total employment in recent years. This proportion has tended to fluctuate year by year, but is well above the 6 percent ratio of the late 1950s. The higher proportion of young workers tends to reduce somewhat average hours and average earnings for all workers. This influence appears to have reached its peak, but much depends on trends in the average number of years spent in school.

Part-time workers

The BLS defines full-time employment as 35 or more hours per week. Part-time workers are those who work less than 35 hours per week—with a range from one to 34 hours.

About 80 percent of all part-time workers do not choose to work full time. They are called “voluntary” part-time workers in contrast to those who are on short weeks for economic reasons. Last year the number of voluntary part-time workers averaged 12.5 million, over 14 percent of all workers. This ratio has increased gradually from under 11 percent in the early 1960s.

In the 16-19 year bracket voluntary part-time workers account for over 46 percent of the total. For women over 20 the proportion is 22 percent; for men over 20 it is 5 percent.

Voluntary part-time employment has increased each year since 1963 (earliest comparison available) when it averaged 7.3 million. It rose in 1975, when total employment declined substantially, although at a slower pace. The uptrend accelerated again last year.

Supplementary income

Part-time workers, both adult women and teen-agers, are often members of families in which the “head” and primary income earner is an adult male. In 1975, latest year available, over 58 percent of the husband-wife families with the husband working had other family members employed. (Many of these other members were full-time workers.) This proportion has risen steadily from 47 percent in 1965 and under 40 percent

in 1955. For working wives alone the ratio was 38 percent in 1975, compared to 29 percent in 1965 and 24 percent in 1955. For families with the head unemployed—2.3 million, on average, in 1975—62 percent reported at least one other member working. The ratio was 45 percent for wives alone.

In 1975 the number of heads of husband-wife families working declined from 38.3 million to 36.8 million. This decline of 1.5 million exceeds the decline of 1.2 million for all workers in 1975. It appears that the heads of households were affected more than proportionately by the recession. Many were fortunate that wives and other members of the family were able to contribute to family buying power.

The flexible work force

With estimated unemployment holding fairly steady at almost 7.5 million in the past year, there is a tendency to view this total as a stable group of people who bear the whole burden. Actually, some of the people classified as unemployed find jobs soon after the survey. Only about one-fifth of the unemployed have been in this category for six months or more. Average duration of unemployment in December was 16 weeks, implying a very substantial turnover in three and one-half months, while the total number of unemployed may have changed only slightly.

The particular individuals who are employed also change from month to month, although not to the same degree as in the case of the unemployed. Some people retire each month; others are seasonal workers; others leave the labor force voluntarily either forever or for periods of time; and some are unemployed part of the year.

In 1976, when employment averaged 87.5 million, about 103.5 million different people had some work experience during the year. For the past decade the number of people with some work experience during the year has exceeded total average employment by almost 20 percent, a remarkably stable proportion. However, this ratio has increased slightly in the past decade for men, while it has decreased for women.

In 1974, the last year for which detailed data are available, men with some work experience during the year exceeded average employment by 12 percent. For women the ratio was 28 percent. As in the case of part-time employment, these comparisons indicate that men are more likely to be permanently attached to the labor force than women.

Further growth ahead

The aggregate figures released each month by the BLS on employment and unemployment reflect the net results of many individual actions. People are losing jobs and finding jobs, changing jobs voluntarily or under pressure, leaving, entering, or reentering the labor force.

In the past 30 years the structure of the labor force has changed significantly. Among the most important developments are the increase in the proportion of women workers, the change in the proportion of young workers, the rise in college enrollment, and the trend toward earlier retirement. These changes were reflected in the labor force participation rate (percent of the non-institutional population 16 years and older), which has trended irregularly upward. In 1976 this ratio was 62.1 percent, a record for the period since World War II. It was 58.9 percent in 1947 and 61 percent as recently as 1972. Changes of 1 percent or more in this ratio reflect a complex of forces that may have profound implications.

Employment is a measure of activity; unemployment of inactivity. Since World War II average employment has declined from one year to another only five times, and never for two consecutive years. The increase from 1975, when employment declined, to 1976 was 3.2 percent. This compares favorably with earlier recoveries: 2.2 percent in 1950, 3.4 percent in 1955, 2.5 percent in 1959, and 1.4 percent in 1962. Employment is expected to rise throughout 1977 and average higher than in 1976, but probably by a smaller ratio than in 1976. Unemployment is expected to decline but not to prerecession levels.

George W. Cloos

Banking insights

Banks now offer savings deposit service to businesses

Effective November 10, 1975, amendments to Federal Reserve System and Federal Deposit Insurance Corporation regulations allowed all insured commercial banks to accept savings deposits from businesses for the first time since 1933. The limit placed on the amount of these deposits is \$150,000 per depositor per bank. Currently, banks can pay up to 5 percent on business savings accounts—the maximum rate permitted on any commercial bank savings accounts. Thus authorized, commercial banks can now compete on more equal grounds for business funds with savings and loan associations (S&Ls), which have not been prohibited from accepting commercial savings deposits.

An investment alternative for businesses

Bank savings accounts provide an alternative investment outlet for businesses with temporarily idle funds, especially small businesses. Before the reintroduction of commercial savings accounts at banks, the business with cash in excess of current needs could (1) hold the funds in currency and/or demand deposits, (2) deposit the funds in savings accounts at S&Ls, (3) purchase shares in money market mutual funds, or (4) make direct investments in money market instruments such as Treasury bills and negotiable certificates of deposit (CDs). A bank savings deposit possesses certain attributes that in some instances offer advantages either as a substitute for or a supplement to these other investment alternatives.

Currency and demand deposits. These rank lowest among the choices in terms of nominal return on investment. But while they bear no explicit rate of interest, they are the most liquid of the investment alternatives—

that is, they can be mobilized for transactions purposes in the shortest period of time (immediately) with the least risk of capital loss (none, abstracting from bank failures or depreciation due to inflation). Moreover, they yield implicit returns in the form of services a bank provides to its depositors. Many banks today, however, are willing to transfer funds from a savings account to a checking account upon telephone notification by the depositor. A business whose bank offers this telephone transfer service may now find bank savings deposits preferable to demand deposits as a temporary repository for idle funds because their higher explicit nominal rate of return is available with little or no loss of liquidity.

Savings deposits at S&Ls. This second alternative may afford businesses higher earnings than comparable deposits at commercial banks to the extent that the S&Ls in the relevant market actually offer the maximum legal rate, which is $\frac{1}{4}$ percent higher than what commercial banks may pay. However, the S&L deposits are not as readily convertible into transactions balances as are bank savings deposits unless the S&L has an agreement with a commercial bank whereby a depositor's funds can be transferred from his S&L account to his bank checking account immediately upon notification by the depositor. This service is offered by some S&Ls, primarily in the larger metropolitan areas. Where it is not offered, the higher liquidity of savings deposits at banks may more than compensate for their lower interest return vis-à-vis their counterparts at S&Ls.

Money market mutual funds. When interest rates on short-term market instruments are above the offering rate on savings deposits, money market mutual funds may be

an attractive investment alternative for businesses. Shares in many of these mutual funds can be purchased in units as low as \$1,000, and some funds permit investors to write checks on their shares. The main drawback of a money market mutual fund is uncertainty of return due to daily fluctuations in short-term interest rates. Certainty of return is much greater in the case of savings deposits since offering rates are changed infrequently, if at all, and then usually with advance notification only at the start of a calendar quarter.

Money market instruments. Businesses can buy and sell money market instruments, but such operations are feasible on an economical basis only to larger businesses and corporations due to the relatively large minimum denominations in which these instruments are issued and the large units in which they are traded in the secondary market. For example, Treasury bills and CDs are issued in minimum denominations of \$10,000 and \$100,000, respectively, and are normally traded in units of \$1 million. Some small businesses would be precluded from purchasing these obligations due to their high minimum denominations. Other small businesses, though not deterred by minimum denominations, find the effective return reduced by transactions costs of purchases and sales in the secondary market. Like money market mutual funds, daily fluctuations in short-term interest rates make the return on direct investments in money market instruments uncertain unless held to maturity.

In summary, savings deposits at commercial banks should prove to be an attractive short-term investment alternative to businesses because these balances are potentially very liquid, have a certain return, and deposits can be made in any amount up to a \$150,000 maximum balance. This last attribute should make savings deposits especially appealing to small businesses. In addition to these features, in periods when short-term market interest rates fall below the rates paid on savings deposits, as has been the case in recent months, such deposits may be preferred

over other temporary investment vehicles even by larger businesses. By opening accounts in more than one bank, a business can invest more than \$150,000. However, few banks offer such an opportunity to a non-customer, especially when the funds appear highly interest-sensitive.

Growth in the Seventh District

Latest data available for all U.S. commercial banks show business savings slightly over \$6 billion in mid-1976. Half of this was accounted for by the large banks in major U.S. cities (weekly reporting banks), which hold 55 percent of all commercial banking assets. In February 1977 business savings deposits at the 55 Seventh District weekly reporting banks averaged \$625 million and accounted for slightly more than 13 percent of the total at weekly reporting banks nationwide.

Except for the large banks, data on business savings are available only from quarterly condition reports. Latest available readings (September 30, 1976) show significant differences in the importance of these deposits among member banks in various size classes in the five district states. (See table.)

These data indicate that, within this district, business savings deposits are most prevalent at banks in Iowa, Michigan, and Wisconsin. In these three states business savings deposits are higher as a percent of total savings deposits in almost every bank size group than in Illinois and Indiana. Moreover, the average amount of business savings deposits per bank is higher in Iowa, Michigan, and Wisconsin in most deposit-size classes. Notable exceptions to this pattern are the smallest banks in Iowa, where business savings deposits are relatively unimportant and the largest banks in Illinois, where the significance of these deposits is much greater than at smaller banks in the state.

Although business savings deposits are not yet as important at Illinois and Indiana banks, their more rapid growth rates in these states over the March-September period indicate that they may be catching up. One reason for the lagging importance of these deposits at Indiana banks is that state banking

laws prohibited business savings accounts at commercial banks until January 14, 1976, two months after the Federal Reserve Board lifted its prohibition.

The greater popularity of business savings deposits at Iowa, Michigan, and Wisconsin banks may be related to the fact that prior to the change in bank regulations permitting these deposits, S&Ls in some areas

of these states had been actively soliciting commercial savings accounts. This had two effects—first, to familiarize businesses with this kind of account and second, to attract deposits away from commercial banks. Thus, when banks were authorized to accept business savings deposits, those that had lost deposits to S&L savings accounts may have been more aggressive in promoting their own

Business savings deposits at Seventh District member banks, September 30, 1976

	Deposit size (million dollars)					All banks
	Less than 10	10-50	50-100	100-500	Over 500	
<u>Illinois</u>						
Amount outstanding (\$000s)	1,629	29,862	40,338	88,722	98,105	258,656
Percent of total savings	1.7	2.0	2.5	3.1	3.8	3.0
Average amount per bank (\$000s)	27	169	611	1,888	16,351	727
Percent increase*	227.8	9.3	12.8	55.9	60.4	42.4
Number of banks	60	177	66	47	6	356
<u>Indiana</u>						
Amount outstanding (\$000s)	110	5,995	9,378	22,052	7,826	45,361
Percent of total savings	0.5	1.4	2.8	2.4	1.4	2.0
Average amount per bank (\$000s)	8	84	469	1,225	2,609	363
Percent increase*	**	38.9	57.4	63.6	146.0	68.4
Number of banks	13	71	20	18	3	125
<u>Iowa</u>						
Amount outstanding (\$000s)	489	18,473	14,814	42,745	—	76,521
Percent of total savings	1.2	3.5	4.1	8.0	—	5.2
Average amount per bank (\$000s)	17	212	823	3,288	—	524
Percent increase*	42.3	8.0	38.6	57.7	—	38.5
Number of banks	28	87	18	13	—	146
<u>Michigan</u>						
Amount outstanding (\$000s)	2,512	25,983	18,742	82,494	199,055	328,786
Percent of total savings	6.2	2.8	3.5	3.6	4.3	3.7
Average amount per bank (\$000s)	140	274	892	3,173	19,906	1,934
Percent increase*	40.4	59.6	55.4	36.0	35.8	38.5
Number of banks	18	95	21	26	10	170
<u>Wisconsin</u>						
Amount outstanding (\$000s)	2,289	20,711	14,842	32,712	23,496	94,050
Percent of total savings	5.4	3.6	3.5	6.2	5.4	4.7
Average amount per bank (\$000s)	120	280	873	2,974	11,748	764
Percent increase*	60.6	43.3	55.4	25.0	38.0	37.0
Number of banks	19	74	17	11	2	123
<u>Seventh District</u>						
Amount outstanding (\$000s)	7,029	101,024	98,114	268,725	328,482	803,374
Percent of total savings	2.9	2.5	3.0	3.8	3.6	3.4
Average amount per bank (\$000s)	51	200	691	2,337	15,642	873
Percent increase*	73.4	27.1	32.6	45.8	44.1	41.0
Number of banks	138	504	142	115	21	920

*From six months earlier.

**None outstanding as of March 31, 1976.

savings accounts in order to regain these deposits. Furthermore, some businesses, familiar with this type of deposit as a result of prior "education" by the S&Ls, may have chosen to open a savings account with a commercial bank because of the typically greater liquidity of bank savings deposits and other bank-customer relationships.

Implications for monetary policy

The emergence of business savings deposits at commercial banks may complicate monetary policy decisions depending on the quantities involved and the type of monetary policy pursued. Since the early 1970s the Federal Reserve System has moved toward a monetary aggregates approach to policy; that is, it has attempted to use its policy instruments to maintain growth rates of $M-1$ and $M-2$ within specified ranges over a reasonable time period.¹ The rationale for this approach is that the monetary authorities are seeking to provide money and credit to the economy in volumes consistent with the achievement of the optimum possible combination of the nation's economic goals. The relationship between the monetary aggregates and income, employment, and price stability goals is learned through observation of the economy's behavior in the past. However, the introduction of business savings deposits at commercial banks can be expected to alter some of these past relationships, and uncertainty about these changes could cause errors in the choice of the appropriate target growth rates for the monetary aggregates.

Suppose that corporations convert what would have otherwise been idle demand deposits into savings deposits at commercial banks. This conversion implies a reduction in the amount of demand deposits and hence $M-1$ (assuming no change in the demand for currency) the public wants to hold at any given level of interest rates. The same level of

economic activity can now be supported with a smaller quantity of $M-1$. The substitution of savings deposits at commercial banks for demand deposits, in and of itself, will reduce the quantity of demand deposits.² If the Federal Reserve were following an $M-1$ target and attempted to restore $M-1$ to its original level, some unintended stimulus to the economy might result.

However, if an $M-2$ target were being pursued under these same circumstances, this problem would not be encountered. No shift in the demand for $M-2$ would occur since the fall in the demand for demand deposits is offset by an equal and opposite change in the demand for savings deposits, also a component of $M-2$. While the demand for the elements comprising $M-2$ has changed, there is nothing inherent in this assumed substitution of savings deposits for demand deposits that requires the Federal Reserve to adjust its $M-2$ target to achieve desired economic effects. Although the savings-demand deposit substitution will not alter the $M-2$ target, it will create excess reserves, which, unless absorbed by the central bank, can lead to an expansion in $M-2$ above its targeted level (see footnote 2).

Of course, there are myriad assets other than demand deposits which bank savings deposits can be substituted for. Depending on what assets are involved in these substitutions, the relationship between growth in the monetary aggregates as now defined and economic performance is likely to change. The dilemma for policy makers is that different kinds of shifts in the composition of asset preferences are taking place simultaneously, and accurate information as to kinds of shifts taking place and quantities involved is not always ascertainable.

Paul L. Kasriel

¹ $M-1$ is defined as currency and demand deposits held by the public. $M-2$ equals $M-1$ plus commercial bank time and savings deposits other than large negotiable certificates of deposit.

²The reduction in demand deposits is likely to be less than the increase in savings deposits since this substitution will create excess reserves, assuming a lower required reserve ratio for savings deposits than for demand deposits. Unless absorbed by the central bank, these excess reserves will provide a base for the expansion of total bank deposits, part of which will probably include demand deposits.

Nonbanking activities of bank holding companies

Although bank holding companies (BHCs) have existed for over three-quarters of a century, their impact on the banking and financial sectors has become significant only in the past decade.¹ Prior to 1971 BHCs were divided into two basic types, multibank and one-bank holding companies. Multibank holding companies (MBHCs) were defined as corporate entities controlling at least 25 percent of the ownership of two or more banks and since 1956 have been required to register with the Board of Governors of the Federal Reserve System. Historically, MBHCs have been used largely to circumvent intrastate and interstate branch banking prohibitions, but in recent years they have been expanding into non-banking areas.

One-bank holding companies (OBHCs), on the other hand, have had a more varied history. Originally, OBHCs were organized by families or individuals to control small banks while at the same time gaining certain tax ad-

vantages offered by incorporation. In other instances large nonfinancial holding companies would acquire a bank to facilitate the availability of banking services for their customers and employees. This latter type was frequently referred to as a “conglomerate” bank holding company [22, 25, 29].

About a decade ago, however, a distinct change occurred in the rationale behind the formation of OBHCs. This marked phenomenon was the bank-originated OBHC, whereby the holding company was formed at the initiative of the bank itself. By so doing, the bank holding company could diversify both the range of financial activities it could perform and the geographic area it served. Prior to the 1970 amendments to the Bank Holding Company Act of 1956, OBHCs were neither required to register with the Board nor were they subject to the act’s restrictions. Many of the activities performed by OBHCs, though financial in nature, were activities prohibited both to banks per se and to

¹The historical and legal development of bank holding companies has been traced in several articles in *Business Conditions* [22, 29, 30]. The banking aspects of multibank holding companies were surveyed in the December 1976 issue [9].

NOTE: Numbers in brackets [] refer to the numerically listed bibliography on pages 20-21. Citations are either to studies the results of which are described in this article or to scholarly elaborations of topics discussed.

registered (multibank) holding companies. The term “congeneric” has frequently been applied to this form of BHC [22, 25, 29].

The rapid growth of OBHCs and their tendency to acquire nonbanking business enterprises raised the spectre of the *Zaibatsu* (large multi-industry combinations common in Japan) dominating the American economy and threatening the traditional separation of banking from commerce. The logic of allowing banks to perform functions indirectly which they could not perform directly was questioned. In addition, the combination of banking with related nonbanking activities could produce anticompetitive effects. These concerns precipitated the inclusion of OBHCs into the act via the 1970 amendments, which restricted OBHCs to the same range of activities permitted MBHCs and also liberalized the criteria for determining the permissibility of new activities.

This article presents, in light of economic analysis and empirical evidence, the issues surrounding BHC entry into nonbanking activities. These issues include the permissible nonbanking activities, diversification, risk and the soundness of BHCs and the banking system, concentration and competition, operating efficiency, and pricing and profitability. Unfortunately, however, the empirical evidence available to decide the issues is scanty because (1) nearly all attention heretofore has been focused on the banking aspects of MBHCs; (2) the gathering and analyzing of data from affiliated nonbanking subsidiaries is extremely costly; and (3) data from nonbanking, nonaffiliated firms operating in nonbanking activities are very limited, thus making meaningful comparisons difficult.

Permissible activities

The list of permissible nonbanking activities for BHCs (see table) has increased only slightly during the last two years²—one new activity was approved, while five proposed ac-

²The regulatory status of nonbank activities as of February 1975 is given in [30, pt. 1, pp. 3-6].

tivities were denied and two were placed “under consideration.” There are apparently three reasons for the slackening. To begin with, the Board has adopted a “go slow” policy toward all BHC expansion, including both new activities and the acquiring of nonbanking firms engaged in activities already permissible. For example, the Board has denied applications to acquire mortgage guarantee insurance companies and firms underwriting and dealing in U.S. Government and certain municipal securities. Although all of these meet the criteria of being “closely related to banking” (see below), the Board apparently did not believe the time and circumstances were “right” for BHC entry.

In addition, it is conceivable that the list of permissible activities is close to being exhausted. To be exempt from prohibition, nonbanking activities must meet a two-part test. First, each activity must be “closely related to banking or managing or controlling banks.” To qualify for exemption, one of the following connections must be made:

- 1) that banks generally have in fact provided the proposed service;
- 2) that banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed services;
- 3) that banks generally provide services that are so integrally related to the proposed services as to require their provision in a specialized form.³

Second, the activity must be “a proper incident” to banking and must pass a “net public benefits” test, requiring that the possible benefits to the public—greater convenience, increased competition, or efficiency gains accruing from the acquisition—outweigh possible adverse effects—increased concentration, decreased competition, or unsound banking practices. Since many of the activities clearly meeting both these criteria have already been approved by the Board, the

³*Federal Reserve Bulletin*, February, 1976, p. 149.

**Status of bank holding company
nonbanking activities under
Section 4(c)(8)**

(as of March 11, 1977)

Activities approved by the Board

1. Dealer in bankers' acceptances²
2. Mortgage banking²
3. Finance companies²
 - a. consumer
 - b. sales
 - c. commercial
4. Credit card issuance²
5. Factoring company²
6. Industrial banking
7. Servicing loans²
8. Trust company²
9. Investment advising²
10. General economic information²
11. Portfolio investment advice²
12. Full payout leasing²
 - a. personal property
 - b. real property
13. Community welfare investments²
14. Bookkeeping & data processing services²
15. Insurance agent or broker—credit extensions²
16. Underwriting credit life & credit accident & health insurance
17. Courier service²
18. Management consulting to nonaffiliate banks²
19. Issuance of travelers checks²
20. Bullion broker²
21. Land escrow services^{1, 2}
22. Issuing money orders and variable denominated payment instruments^{1, 2, 4}

Activities denied by the Board

1. Equity funding (combined sale of mutual funds & insurance)
2. Underwriting general life insurance
3. Real estate brokerage²
4. Land development
5. Real estate syndication
6. General management consulting
7. Property management
8. Nonfull-payout leasing¹
9. Commodity trading¹
10. Issuance and sale of short-term debt obligations ("thrift notes")¹
11. Travel agency^{1, 2}
12. Savings and loan associations¹

Activities pending before the Board

1. Armored car services²
2. Underwriting mortgage guarantee insurance³
3. Underwriting & dealing in U.S. Government and certain municipal securities^{2, 3}
4. Underwriting the deductible part of bankers' blanket bond insurance (withdrawn)¹
5. Management consulting to nonaffiliated, depository type, financial institutions^{1, 2}

¹Added to list since January 1, 1975.

²Activities permissible to national banks.

³These were found to be "closely related to banking" but the proposed acquisitions were denied by the Board of Governors as part of its "go slow" policy.

⁴To be decided on a case-by-case basis.

number of future additions to the list of permissible activities is likely to be small. In February the Board determined that the ownership of savings and loan associations by BHCs is not a permissible activity. Although considered "closely related to banking," in the Board's view the potential adverse effects of affiliation with banking outweigh the potential benefits.

Lastly, the adverse economic conditions during the 1973-75 period caused serious financial problems for some BHCs resulting in the fall of BHC stock prices and contributing to the Board's "go slow" policy. Many BHCs have been reluctant to push for either new activities or new acquisitions, which has been reflected by a considerable reduction in BHC applications of both types being submitted to the Board in recent years. However, as economic conditions improve, this trend is likely to be reversed [26].

The Board has been criticized by some for being too permissive with respect to the activities BHCs are allowed to perform, while it has been criticized by others for being too restrictive. Clearly, both criticisms cannot simultaneously be correct, and they serve to highlight certain problems faced by the Board in ruling on proposed activities.

First, the words "closely related to banking" in Section 4(c)(8) of the act are extremely vague. Essentially, the interpretation was left up to the Board, subject to judicial review. To some degree the Board may feel constrained by what it believes the courts will accept.

Second, it appears that the Board, in making its determinations on activities, considers those activities which are permissible for national banks. With a few exceptions the permissible activities for bank holding companies and national banks are nearly identical (see table). Thus the range of activities BHCs may perform is not very different from that of many banks.

Two other facets of the controversy over the nonbanking activities of BHCs should be noted. While the list of permissible activities is impressive, BHC entry by acquisition has been predominantly limited to three areas: consumer and commercial finance, mortgage

banking, and insurance (underwriting and broker or agency) [26]. De novo entry has, by and large, been limited to these three plus leasing and advisory services. Intuitively, these activities seem to afford the greatest opportunity for the application of banking expertise.

Given the controversy surrounding the importance and range of nonbanking activities, one would expect that these activities constitute a relatively significant proportion of the BHC organization. Quite the contrary is true, however. Currently, nonbanking subsidiaries account for less than 5 percent of the total consolidated assets of BHCs [8, 32] and about 3 percent of the assets of the largest 50 BHCs [33].

Risk, soundness, and BHCs

Perhaps the most important and controversial current issue regarding entry of BHCs into nonbank activities has been the impact of such expansion and diversification upon the integrity and soundness of affiliate banks, the holding company, and the banking system. Although BHCs entered nonbanking areas en masse following the 1970 amendments, entry into these activities has subsided while the controversy has continued.

Proponents of BHC expansion argue that through acquisition of nonbank subsidiaries, the overall level of risk for a given level of return can be lowered, thereby strengthening the BHC and, consequently, the banking system. Performance of nonbank activities allows a BHC to diversify both by activity and by geographic market area, especially since nonbank activities may be performed across state lines. Ever since the advent of multiproduct and multimarket firms, the logic of diversification has been employed by firms in nonregulated industries to stabilize the profitability of the total organization by insulating it from seasonal or cyclical variations affecting the organization's component divisions.

Opponents of BHC expansion question whether entry into nonbank activities has actually stabilized the banking industry by

reducing risk per dollar of investment. They also raise issues regarding permissible types of risks for BHCs.

The spectrum of alternatives ranges from permitting BHCs to engage in no activity riskier than traditional banking services to allowing BHCs to undertake activities considered much riskier than the basic functions of banking. The Board's position on BHC activities appears to be about midway between these two extremes.

The assessment of risks differs among depositors, managers, owners, and regulators. The Board, however, must view the riskiness of nonbank activities within the context of safety for the entire banking system, a constraint not imposed by the other groups. That is, the Board must consider the riskiness of each activity with respect to the bank affiliate and ultimately upon the banking system, whereas the other groups view the bank affiliate as one of several activities to be performed by the enterprise.

Economists and financial analysts disagree over methods for quantifying risk, giving rise to many views regarding the identification and objective measurement of various risks. Consequently, the relationship between diversification and risk and the resultant impacts on the soundness of individual BHCs and the entire banking system is difficult to assess.

Risk is essentially the lack of perfect knowledge in making decisions. A relevant measure of BHC performance is the mean, or average, rate of return either on assets or equity capital. A frequently used, but not universally accepted, statistical measure of risk is the standard deviation (or variance) of the rate of return, which shows the dispersion (variation) of the profit rate about its average value.

Two principal views exist regarding the relationship of risk, diversification, and permissible BHC activities. One view holds that risk, measured by the standard deviation or variance of the rate of return alone, is a sufficient criterion for determining the desirability of entering nonbank activities. Any activity having a greater variance in its

rate of return than banking is defined as being riskier than banking, and some analysts extend this to say these should not be permissible activities. A second view holds that variance alone is not a sufficient criterion. Rather, the proper criterion in evaluating activities should be risk relative to the expected, or average, return, although some upper limit to the amount of risk appropriate for BHCs to assume is probably implicit.

In combining two activities, risk becomes a function not only of the individual variances, but also of the degree of correlation between the profit rates of the activities. If the profit rate of two activities exhibits negative correlation, the variance of the combined profit rate, and thus the risk, will be lower than each activity taken alone. If the activities are positively correlated, the advantages of diversification may still exist. Combining activities having positive correlation between the rates of return may possibly increase the total risk but reduce the risk relative to the total level of production. The return to the BHC, as with any investment portfolio, is likely to be more stable the wider the range of activities (industry securities) held. In general, firms in the same industry are more likely to do poorly at the same time than are firms in unrelated industries.

An interesting situation arises regarding those activities that pass the "closely related to banking" test of Section 4(c)(8) of the act. The more closely related the nonbank activity is to banking, the more likely there will be a positive correlation between the profits of that activity and banking, and the smaller the advantages arising from the diversification principles. BHCs can, therefore, reduce their relative risk exposure most by expanding into the nonbank areas most remote from banking (unless earnings variances are a great deal higher than in banking). From 1956-70 only one activity—banking—was explicitly permitted bank holding companies by the act, and little exercise of the diversification motive was open to BHCs.

The justification for diversification is not solely restricted to the expected reduction in the variation of profits. Diversification also

helps mitigate uncertainty; in particular, by lessening a BHC's dependence on one activity, it reduces the potential losses if that activity were to become obsolete or unnecessary.

Before we can make any assessment of the impact diversification has had upon the soundness of the banking system, we must know the risk levels associated with each of the nonbanking activities BHCs are likely to enter, as well as the degree of correlation between their profits and profits in banking.⁴

Because nonbanking activities are required to be "closely related to banking," one might expect the correlation between the profits of banking and several of the nonbanking activities to be positive since they would be subject to common influences. While limited empirical evidence exists on this issue, one study indicates that the profits of several permissible nonbank activities are negatively correlated with bank profits, suggesting that it is possible to significantly reduce a BHC's level of overall risk by diversifying into these activities [14]. For example, the returns in insurance and real estate financing tend to be high when returns in banking are low. On the other hand, the profitability of other nonbank activities—such as business credit, consumer credit, and loan servicing—exhibits a positive correlation with bank profits. The different leasing functions have mixed correlations. These correlations are based upon the profits of each industry and are predicated on the activities being performed independently. Once banking is combined with another activity under the same corporate umbrella, these correlations may no longer hold.

With respect to measuring the degree of risk in various activities, the evidence is somewhat contradictory. One study, measuring risk by the coefficient of variation of industry profit rates (the standard deviation of the profit rate divided by the average profit

rate), found banking to be one of the most risky activities that BHCs are allowed to perform [14]. Another study, measuring risk by the standard deviation in the monthly rate of return on the common stock of firms in various industries over the 1961-68 period, found banking to be the least risky of the activities considered [11]. While both studies have shortcomings, the latter was characterized by a very small sample size (e.g., only 19 banks, two mortgage banking firms, one insurance company). Moreover, the return (and standard deviation) was computed on a monthly basis, which would seem to be meaningful only from the viewpoint of the small investor. The actual annual profits of the firm—an item of major interest to managers, controlling owners, and regulators in assessing risk—were ignored in the study.

Thus, empirical evidence currently is not sufficient to judge which nonbanking activities, taken in isolation, are more risky than banking and which are less risky; nor is it adequate to identify those activities having the greatest stabilizing effect on holding company profits.

While the variation in and correlation of profits are important concerns in dealing with soundness, they are not the only concerns. Another is the problem of capitalization, both of the BHC and of the nonbank affiliate. The question has been raised whether parent holding companies tend to be undercapitalized [5, 21, 34], and there is some evidence to indicate that they are [21]. Also, some evidence suggests that BHC nonbank affiliates in consumer finance and mortgage banking have lower equity capital-to-total asset ratios than the respective industry standards [35] (referred to as leverage, but this is only one of several possible definitions in use). Whether BHC nonbank subsidiaries in other activities are more highly leveraged than their nonaffiliated competitors is not known. Furthermore, the statistical methodology is somewhat faulty in that no effort was made to measure each firm's leverage ratio prior to acquisition. It is conceivable that the preacquisition leverage was also higher than the industry standards.

⁴Industrial firms practicing diversification have not enjoyed unequivocal success. Diversification *per se* may not have been the cause of this lack of success, however, since too rapid growth and expansion, undercapitalization, and adverse economic conditions may also have contributed to their lackluster performance.

In the final analysis, however, a more preferable method of evaluating the soundness of the banking system might be to simultaneously examine the mean and variance of earnings *and* the capital structure [36]. While this approach seems intuitively appealing, most studies have focused on one or the other.

Other factors play important roles in determining the soundness of the banking and financial sectors. For example, the soundness of any business entity depends upon the degree to which it is legally insulated from the other bank or nonbank companies with which it is affiliated. Soundness also depends upon the degree to which BHCs provide their affiliates with financial and managerial resources, thereby strengthening the affiliates. By instituting more aggressiveness and risk into the operating policies of affiliates or introducing intersubsidiary transactions having the eventual effect of weakening the bank or other affiliates, BHCs could significantly weaken themselves and the banking and financial sectors. These considerations are important, but at the present time we have little knowledge of their extent and impact.

In sum, it appears at this time that we are a long way from having any definite knowledge of the impact of the nonbank activities of BHCs upon the soundness of the banking and financial sectors. The partial evidence which is available provides tenuous answers at best. As a final thought, it should be noted that even if entry into the nonbank activities were to reduce the risk of failure for the BHC, the external social cost of failure will very likely rise because as the organization becomes larger, the absolute cost of failure both to the organization and to the financial system also becomes greater [5]. Therefore, the net effect depends on what happens to the "expected cost" of failure, obtained by multiplying the increased cost of failure by the reduced probability of occurrence.

But, to the extent that nonbank expansion is a substitute, rather than a complement, to bank expansion, the overall size of BHCs need not increase.

Concentration and competition

After the 1970 amendments were passed, BHCs moved rapidly into many of the permissible nonbanking areas, creating concern about the impact this expansion would have upon the concentration of economic resources.⁵ One of the primary factors the Board is required to consider under Section 4(c)(8) of the act is the prevention of "an undue concentration of resources." Typically, concentration is discussed at three levels: aggregate or nationwide concentration, statewide concentration, and local or market concentration. Unfortunately, comment on the effects of nonbanking activities upon statewide concentration is not possible at this time because no work has been done in the area.

Aggregate concentration. Since BHCs participate in banking as well as nonbanking (but closely related to banking) activities, the phrase "concentration of resources" must refer to financial resources. Between 1966 and 1973 the share of total financial assets held by the largest 100 BHCs increased from 16 percent to 29 percent [33].⁶ While this increase is substantial, it is questionable whether a 29 percent share accounted for by the largest 100 firms constitutes undue concentration by the standards of most U.S. "industries." It should be kept in mind, however, that BHC entry into the nonbanking areas has not been uniform across activities.

On the other hand, it does not appear that BHC entry into nonbanking activities, per se, has been a major contributor to this increase in aggregate concentration. The Board has limited entry into these activities largely to either de novo or foothold entry; as a result, nonbank assets account for less than 5 percent of consolidated holding company assets for all U.S. BHCs and only 3 percent for the largest 50 BHCs. While the amount of assets

⁵For a fuller conceptual discussion of concentration and competition, see [9].

⁶Excluding foreign branch assets, however, the figures are 15 percent and 24 percent, respectively. The largest relative increase has thus been in this category.

held in nonbank activities has been growing, it does not explain the 13 percentage point increase in the share of financial assets held by the 100 largest BHCs. Rather, this change appears to be more likely a result of the increased use by large banks of nondeposit sources of funds to finance asset growth.

Local (market) concentration. Market concentration is, by far, the most important measure of concentration because it is most closely associated with the degree of competition in a local area [9]. While there is no direct evidence on this issue with respect to nonbank activities, it may be possible to get some insight into the future by looking at the Board's policies related to permissible forms of entry into nonbank activities.

The Board seems to be following a two-part policy regarding BHC entry into the nonbanking areas. First, the acquisition of large firms (i.e., firms having a large share of the market) is discouraged [17]. Second, entry into new markets by either *de novo* or foothold means is encouraged. In particular, the Board has made *de novo* entry administratively much simpler than the acquisition of a going concern. *De novo* entry has been emphasized because it adds a new decision maker to the market and increases the number of competing firms, thereby raising the likelihood that BHC entry will have a procompetitive effect. *De novo* entry would probably be less prevalent in the absence of the act and the Board's enforcement policies.

With regard to credit services it is possible that BHC activity has improved the allocation of financial resources. Being able to expand geographically, especially interstate, has allowed BHCs to compete over a wider area, and thereby offer credit in locations where the demand is greatest.

At the same time, however, the magnitude of mortgage lending has apparently not been affected by BHC affiliation. Preliminary evidence indicates affiliated mortgage banks grow no faster than nonaffiliated mortgage banks, while commercial banks neither increase nor decrease their mortgage lending activity upon affiliation with a mortgage bank [27].

Operating efficiency

Improved operating efficiency for nonbank firms is a commonly cited benefit of affiliation with a bank holding company. That is, through affiliation, the nonbank firm can potentially achieve some cost reductions through the parent holding company's ability to generate new business for the nonbank affiliate, thus increasing the affiliate's level of output. If the affiliate is operating on the downward sloping portion of its average cost curve, this increase in output could then be translated into lower unit cost. The public would benefit if and when this lower unit cost is passed on in the form of lower charges. Even if they are not passed on, lower operating costs would increase the profitability of the bank holding company, thus enhancing the strength of the banking and financial systems.

A second source of potential cost savings arises from economies of affiliation, which could result if some of the functions previously performed by the independent firm were centralized at the BHC level or if the purchase of some inputs was centralized. For example, since the parent company may have greater access to the capital market, it may be able to acquire capital funds for the affiliate at a lower rate than an independent firm of equal size could obtain.

While these arguments have intuitive appeal, at the present time there is no evidence to support them. No systematic effort has been made to study empirically the impact of BHC affiliation upon the operating costs of nonbanking firms. On the other hand, studies examining the impact of affiliation upon banking firms indicate that affiliated banks, for some reasons, have higher costs than independent banks [9]. While the exact causes of this phenomenon have not been determined, one possible reason is that affiliate banks are subject to higher charges from the nonbank subsidiaries or the parent holding company [9]. A definitive judgment cannot be made at this time as to the impact of affiliation upon the operating efficiency of

firms engaged in nonbanking activities; more work needs to be done in this area.

Pricing and profitability

Pricing. In the eyes of the Board public benefits arise from BHC performance of non-bank activities when affiliates charge lower prices for any given service than their nonaffiliated competitors. Empirical evidence on this issue is sparse and provides little insight. The only nonbanking activity about which there is any evidence is insurance underwriting. Regulation Y stipulates that BHCs cannot underwrite credit life, accident, or health insurance unless the premiums charged are less than the ceiling rates established by the state. According to a recent study analyzing the results of this policy, rates charged by BHC affiliates in 1974 resulted in approximately a 13 percent savings in premiums [28].

Profitability. Because of the lack of information concerning either the operating efficiency or pricing of nonbank affiliates, the impact of affiliation on the profitability of nonbank companies cannot be predicted. However, a recent study covering 1973 and 1974 indicates that the rates of return on invested capital in two of the more popular nonbank activities—mortgage banking and consumer finance—are considerably lower for BHC affiliates than for each respective industry as a whole [35]. There are at least three

reasons for this occurrence. First, because of their comparatively recent entry into these activities, BHC affiliates could be charging lower prices in an effort to attract customers from their longer-established competitors; second, affiliates could be incurring higher costs; or third, affiliates could be carrying higher levels of invested capital than the average firm in the industry (which contradicts Talley's study). Some combination of the three is also possible. At the present time, however, which influences may predominate is not ascertainable. Additionally, because the profitability of these firms prior to affiliation is not known, their lower rates of return may not be due to affiliation.

Summary

Nonbanking activities of BHCs are a hotly contested issue which will become even more heated in the future. To draw any definitive conclusions, based on evidence available at this time, about the efficacy of BHC entry into the nonbanking areas and the resultant impact on the financial system would be overstepping the bounds of credibility. Evidence to support any conclusions is lacking both in quantity and quality, and unfortunately, if historical experience is a guide, probably half a decade will pass before we are in a position to make a more definitive declaration.

Dale S. Drum

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State and local government deposits in the district

Laws and deposit allocation

Individuals and business firms in the United States have a significant amount of latitude in selecting financial institutions that will meet their needs for depository services. The choice may be made from any of the more than 14,000 commercial banks located in the 50 states, although in practice, most small account owners limit themselves to locally available alternatives. In addition, depository services are provided by approximately 5,000 savings and loan associations, more than 475 mutual savings banks, and more than 22,000 credit unions. While certain economic factors—such as transactions cost and travel time needed to conduct business—and non-economic considerations—such as convenience of location—tend to influence the private sector's selection of alternative financial institutions, there are few legal barriers that have a direct impact upon the depository selection process. The one important legal barrier that limits the choice is that nonbank financial institutions are prohibited in most states from offering demand deposit services.

On the other hand, state and local governments, in selecting institutions that will meet their needs for depository services, are subject to specific statutory and constitutional restrictions tending to limit their alternatives, usually as to type and location of institution. As such, laws that influence the allocation of public funds between and among various banks and other types of financial institutions have a definite impact upon the structure of banking. This article examines the legal framework influencing the allocation of state and local deposits and analyzes the impact of these laws upon the banking structure of the five Seventh District states—Illinois, Indiana, Iowa, Michigan, and Wisconsin.

State and local deposit importance

In both absolute and relative terms deposits of state and local governments are becoming increasingly important items on the balance sheets of the nation's commercial banks.

In a 1961 study the Advisory Commission on Intergovernmental Relations noted that as of June 1959, "Of the approximately \$14.2 billion on deposit by state and local governments \$3.7 billion was on time deposit and \$10.4 billion on demand deposit."¹ By June 30, 1975 total deposits of state and local governments in commercial banks had grown to approximately \$67.0 billion, of which \$48.5 billion was in the form of time deposits and \$18.5 billion was in the form of demand deposits.² The data reveal that during the past 16 years (June 1959-June 1975) total state and local deposits held by commercial banks have grown at a compounded annual rate of approximately 10.2 percent, while individual, partnership, and corporate (IPC) deposits (i.e., private sector deposits) grew at only a 7 percent compounded annual rate. Of equal significance is the reversal of the composition of those deposits. Whereas in 1959 demand deposits constituted the major portion of total state and local deposits (approximately 73.3 percent), as of June 30, 1975 time deposits accounted for the major portion of total state and local deposits (approximately 72.4 percent). During the 16-year period state and local government demand deposits have

¹*Investment of Idle Cash Balances by State and Local Governments*, Advisory Commission on Intergovernmental Relations, Washington, D.C., January 1961, p. 14.

²*Assets and Liabilities: Commercial and Mutual Savings Banks*, FDIC, December 1975.

grown at a compounded annual rate of only approximately 3.6 percent, whereas, time deposits of state and local governments over the same period have grown at a compounded annual rate of approximately 17.5 percent, a 13-fold increase.

Figure 1 illustrates the growth and changing composition of state and local deposits over the 16-year period 1959-75. The change from demand to time deposits reflects the growing concern on the part of state and local governments to invest their idle cash balances so as to maximize earnings on public funds, a concern heightened by the increase in average interest rate levels over this period.

Further insight into the growing importance of state and local government deposits is revealed in the analysis of the overall composition of commercial bank deposits. In June 1959 state and local government deposits accounted for 6.8 percent of total deposits in insured commercial banks. By June 1975 state and local deposits constituted 8.8 percent of total deposits in all commercial banks.

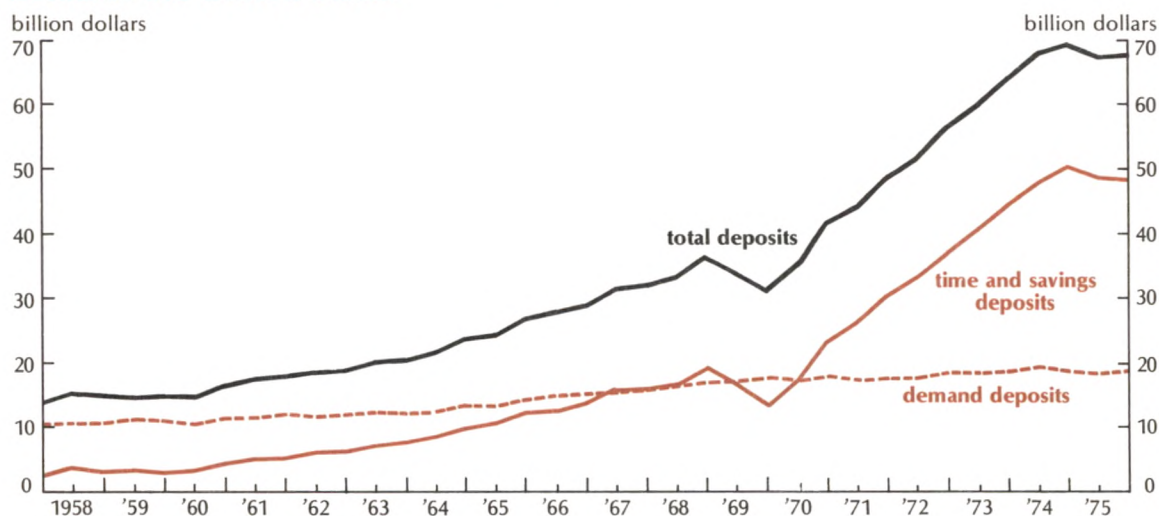
Except for "small banks" (deposits less than \$1 million) state and local deposits have become an increasingly important source of funds for banks of all sizes. As shown in Table

1, state and local deposits as of June 1959 amounted to over 11 percent of the total deposits in "small banks" but accounted for only 4 percent of total deposits held in the nation's largest banks, i.e., those with deposits of \$1 billion or more. Since 1959 state and local deposits have become less important deposit sources at "small banks" and increasingly important sources of deposits for "large banks." In 1959 only one bank group (those with less than \$1 million in deposits) had state and local deposits that constituted 10 percent or more of their total deposits. In 1975 two groups of banks held state and local deposits that represented about 10 percent of their total deposits, and in one group state and local deposits accounted for over 11 percent of the total deposits. Thus, state and local government deposits are becoming a more significant item on the balance sheets of commercial banks.

There are 16,092 local governments in the Seventh Federal Reserve District, including county, municipal, and township governments, and school and special districts.³ This represents about 20.6 percent of all local

³Census of Governments, 1972, Bureau of the Census, U.S. Department of Commerce.

Figure 1. State and local deposits held by all commercial banks in the United States



SOURCE: Assets and Liabilities of Commercial and Mutual Savings Banks, FDIC, various years.

Table 1
Deposits of state and local governments by
commercial bank size

Deposit size of banks	June 10, 1959			June 30, 1975			Relative change 1959-1975 (6) - (3)
	(1)	(2)	(3)	(4)	(5)	(6)	
	Total deposits (millions)	Total state and local deposits (millions)	(2) ÷ (1) (percent)	Total deposits (millions)	Total state and local deposits (millions)	(5) ÷ (4) (percent)	
Less than \$1 million	997.5	117.7	11.8	86.6	6.3	7.3	- 4.5
\$1 to 10 million	33,997.3	3,312.8	9.7	31,954.5	3,199.7	10.0	+ 0.3
\$10 to 100 million	53,425.6	4,283.4	8.0	215,518.8	22,169.4	10.3	+ 2.3
\$100 to 1 billion	63,650.9	4,297.9	6.8	212,500.5	23,747.5	11.2	+ 4.4
\$1 billion or more	54,634.3	2,142.2	3.9	297,624.8	17,771.1	6.0	+ 2.1
TOTAL	\$206,705.7	\$14,154.1	6.8	\$757,718.2	\$66,894.1	8.8	+ 2.0

Note: Data for 1959 is for insured banks, whereas data for 1975 is for all banks. Numbers may not add due to rounding.

SOURCE: FDIC, *Annual Report*, December 31, 1959 and FDIC, *Assets and Liabilities of Commercial and Mutual Savings Banks*, June 30, 1975.

governments in the United States. Illinois, with 6,385, leads the Seventh District and the nation in the number of local governments. Indiana, Michigan, Wisconsin, and Iowa have, respectively, 2,792, 2,649, 2,448, and 1,818 local governments. As of June 30, 1975 state and local deposits held by all insured commercial banks within the Seventh District states aggregated approximately \$12 billion. As such, state and local deposits represent approximately 9.3 percent (see Table 2) of all deposits held by insured commercial banks within these states, slightly above the national average of 8.8 percent.

Of the \$12 billion of state and local deposits held by commercial banks in the five states, 74.3 percent was held in time accounts and 25.7 percent was held in demand accounts. Relative to the nation as a whole, these figures indicate that, in the aggregate, state and local governments in the district states tend to hold a slightly larger proportion of their total deposits in the form of time or savings accounts (the national average is 72.4 percent). Table 2 further reveals a con-

siderable degree of variance in the importance of state and local deposits as a source of funds to commercial banks in the five states. For example, state and local deposits constitute only about 6.7 percent of total deposits held by insured commercial banks in Iowa but 13.4 percent of total bank deposits held by Indiana commercial banks. Also, Indiana, relative to the four other states, holds the lowest percentage of state and local deposits in the form of time and savings deposits (60.3 percent). State and local governments in Michigan, on the other hand, maintain about 79.4 percent of their total deposits in time and savings accounts.

Major concerns

Governmental bodies, just like businesses and private individuals, are faced with the problems of investing their idle funds. For state and local governments "idle funds" are created by the lack of synchronization between the receipt of revenues and the outflow of cash expenditures. Since state and

Table 2
Deposit composition of insured district banks
as of June 30, 1975

	<u>Illinois</u>	<u>Indiana</u>	<u>Iowa</u>	<u>Michigan</u>	<u>Wisconsin</u>	<u>Total</u>
	(billion dollars)					
Total demand deposits	20.218	5.924	3.794	9.113	4.592	43.641
Total time deposits	37.502	10.972	7.129	19.905	9.834	85.342
Total deposits	57.720	16.896	10.923	29.018	14.426	128.983
Demand deposits of state and local governments	1.022	.895	.241	.646	.264	3.068
Time deposits of state and local governments	3.555	1.361	.494	2.491	.992	8.893
Total state and local deposits	4.577	2.256	.735	3.137	1.256	11.961
State and local deposits as a percent of total deposits	7.93	13.35	6.73	10.81	8.71	9.27

local government revenues are not received in sufficient amounts on the day they are required to meet an expenditure, funds must be accumulated prior to actual expenditure or the governmental unit must be able to borrow needed funds. Most state and local governments have little if any excess idle cash at the start of their fiscal years. However, idle cash may begin to accumulate later as revenues begin to exceed expenses. At this point the governmental body must decide how to invest these funds. Traditionally, public finance doctrine has specified that consideration be given to four factors: legality, safety, liquidity, and yield.⁴ Some governments have added a fifth factor to this list: the promotion of particular social goals.

• **Legality.** State constitutions and statutes frequently specify the types of institutions and financial instruments in which public funds may, or may not, be employed. For ex-

ample, the Michigan Constitution precludes savings and loan associations from acting as depositories for state funds. Thus, public officers must be aware of the legal limitations involved when they invest public funds.

• **Safety.** Speculation with public funds is prohibited by law, and state statutes frequently specify that only the safest and most secure types of investments be permitted. For example, the Indiana courts have noted that a public depository law was adopted primarily for the security and protection of public funds against the "devious methods and rascality of dishonest public officials."

• **Liquidity.** Money must be available when needed. If public funds are invested in long-term obligations, which are not readily marketable and which fluctuate greatly in value, a public body faced with a decline in revenue may be forced to borrow funds at an unfavorable rate.

• **Yield.** After complying with legal requirements, providing for safety and ensuring liquidity, investments that will produce a maximum yield may be considered. Obvious-

⁴See for example: *Investment of Idle Funds by Local Governments: A Primer*, John A. Jones and S. Kenneth Howard. Municipal Finance Officers Association, Chicago, Illinois, 1973.

ly, after complying with the first three constraints, the scope of investment options available with regard to type of financial institution and type of financial instrument is somewhat limited. For small governmental bodies with small amounts of funds to invest, the alternatives frequently narrow down to time deposits at commercial banks and short-term U.S. Treasury obligations.

• **Social goals.** Certain state and local governments may and do invest their funds in order to achieve or promote certain social goals. For example, some governments may desire (or be required by law) to invest and deposit idle funds only with banks located in-state, in-county, or in-city with the intention of fostering local development and economic growth. The rationale is that state and local government funds will be used by local banks to promote local investment, which will generate more local income and employment and thus tax revenues. Whether this developmental objective will be achieved depends on the use banks make of these funds (i.e., whether or not they are locally invested) and the size of the income multiplier associated with locally used funds.

Table 3
Deposits held by the five largest commercial banks in each district state as of June 30, 1975

Rank of bank in state	Bank's IPC deposits		Bank's state and local deposits	
	(billion dollars)	(percent) ¹	(million dollars)	(percent) ²
<u>Illinois</u>				
1	7.984	16.3	395	8.6
2	6.616	13.5	529	11.6
3	2.016	4.1	118	2.6
4	1.591	3.3	153	3.3
5	.906	1.9	20	0.4
<u>Indiana</u>				
1	1.017	7.3	163	7.2
2	.956	6.8	174	7.7
3	.508	3.6	107	4.7
4	.324	2.3	39	1.7
5	.270	1.9	62	2.8
<u>Iowa</u>				
1	.283	2.9	37	5.0
2	.204	2.1	19	2.6
3	.152	1.6	08	1.1
4	.136	1.4	22	3.0
5	.131	1.4	20	2.7
<u>Michigan</u>				
1	3.781	15.6	437	13.9
2	2.259	9.3	114	3.6
3	2.090	8.6	145	4.6
4	1.014	4.2	236	7.5
5	.687	2.8	106	3.4
<u>Wisconsin</u>				
1	1.108	8.8	195	15.5
2	.421	3.3	91	7.2
3	.251	2.0	41	3.3
4	.179	1.4	21	1.7
5	.165	1.3	97	7.7

¹Bank's IPC deposits relative to total commercial bank IPC deposits in the state.

²Bank's state and local deposits relative to state and local deposits held by all commercial banks in the state.

Primary factor influencing allocation

Every state and local government has differing investment objectives; some are faced with staffing restrictions and others have

Illinois depository laws

Chapter 130 of the Illinois Statutes sets forth the major legal parameters for the deposit of state monies. The law requires that at least once a year the state treasurer notify "regularly established" national and state-chartered banks doing business in Illinois concerning sealed bids for the deposit of public monies in his custody. As worded, the law excludes all but commercial banks located in Illinois from holding state monies. Two classes of depositories—time and demand—are required. Securities at least equal in market value to funds deposited must be pledged by banks holding state funds. However, no such securities are required for funds insured by the Federal Deposit Insurance Corporation.

The law requires that at all times at least 20 banks be approved depositories for time deposits. Only the state's two largest commercial banks, out of the 1,187 in the state, hold demand deposits, which are compensating balances for clearing checks and other necessary services. There is no legal restriction on the total dollar amounts of Illinois state funds that can be placed in any one financial depository. However, no bank can hold state funds until it certifies that it does not engage in discriminatory lending practices and pledges within the limits of its legal restrictions and prudent financial practices, to make loans available on low- and moderate-income residential property.

The state treasurer's investment program currently employs three different means by which state funds are allocated among commercial banks.

Under the first program, the Basic Deposit Program, time deposits are awarded for one-year periods to any Illinois bank, except for major Chicago banks (the five largest banks in the state), that applies and meets certain criteria. Factors considered include the amount of loans outstanding, the rate bid, and the size of the bank. The second and third investment programs employ the "linked-deposit" concept. Under these programs time deposits are allocated among bidding banks on the condition that specific lending functions are being or will be performed by each bank.

The second program—the Specific Opportunity

Program—allocates time deposits to those banks willing to participate in the financing of one or more projects. For example, in the past, time deposits have been allocated to banks that have granted loans for pollution abatement projects or to rural banks to encourage them to make agricultural loans.

The third program—the Community Service Program—utilizes the "linked-deposit" concept to allocate state deposits on the basis of the bank's past history of involvement in making community service oriented loans. Under this program funds are allocated annually for a one-year period, and banks must bid at or above a predetermined minimum rate set by the state. Banks bidding above the minimum rate receive larger deposits. In addition, the banks must report their outstanding loans in 13 categories. Among these categories are bank purchases of local tax anticipation warrants, student loans, agricultural loans, Small Business Administration loans, construction financing for public housing projects, and pollution abatement loans.

For Illinois counties the county boards, when requested by the county treasurer, are required to designate one or more banks or other depositories in which county funds may be deposited. The law does not require that institutions selected as depositories bid for county funds. However, the law does stipulate that county funds deposited in any one bank "shall not exceed 75 percent of the capital stock and surplus of such banks." The county treasurer may require that securities equal in market value to the amount of the funds deposited be pledged by the depository.

Illinois law states that a municipal treasurer may deposit public funds in places designated by local ordinance and that the corporate authorities shall designate a bank or banks to act as public depositories. Like county deposits, municipal funds, except for deposits of the city of Chicago, cannot be deposited in a designated bank in excess of 75 percent of the bank's capital stock and surplus. Illinois law places neither geographic restrictions on the location of banks nor does it require the establishment of a bidding system for municipal funds.

differing management philosophies, all of which have an impact upon the allocation of state and local deposits. However, state and local laws comprise the primary factor that influences the allocation of state and local deposits. In every state a body of laws has evolved that determines the types, location,

and size of institutions as well as types of instruments in which public funds may be invested. For the most part these laws emphasize safety. Public officials charged with handling public funds determine the specific allocation based upon the legal guidelines, of which their power, however, is

Indiana depository laws

Section 5, Article 12 of the Indiana Statutes contains the major provisions of the state's public depository law. The Indiana Department of the Treasury is required to publish, 20 days before its biennial meeting, a notice inviting proposals from banks and trust companies for the deposit of state funds. Institutions desiring to act as state depositories must be located within the state. There is no bidding system per se for state funds in Indiana. Any bank "suitably located with reference to the convenience of the officers and state institutions using them" and agreeing in its proposal to provide the necessary security is designated as a depository for state funds. Although the law is somewhat vague with respect to the allocation of state funds among the designated depositories, the treasurer maintains balances in each depository, as nearly as practicable, in proportion to the total resources that each depository bears to the total resources of all designated depositories. The state may deposit idle funds in certificates of deposit in any national, state, or mutual savings bank with its principle place of business in the state. With certain exceptions, the treasurer cannot deposit funds in certificates of deposit in any one bank in an amount aggregating more than 50 percent of the combined capital, surplus, and undivided profits of the institution. As of June 1975 the state had time deposits in 396 of the state's 406 commercial banks and three of the four mutual savings banks. Between January and June 1975 the state of Indiana maintained demand deposits in 16 of the state's commercial banks.

The Indiana Depositories Act does not require the designated depositories to pledge assets as

collateral for state and local funds held on deposit because the state has an established public depositories insurance fund. Under this system the board of depositories—consisting of the governor, treasurer, auditor, chairman of the commission for financial institutions, and chief examiner of the state board of accounts—is charged with establishing an assessment rate and base for the insurance fund. The assessment base is determined monthly and is defined as the sum of all the minimum balances of public funds on deposit in each and all accounts during the month. Every depository of public funds is required to pay the assessment rate established by the board of depositories. The rate may not exceed 2 percent per annum and the maximum reserve for losses may not exceed 10 percent of the average monthly deposits of public funds on deposit in depositories during any one month.

The requirements for the designation and allocation of funds of Indiana counties, cities, townships, etc., largely parallel the requirements for the state, with a few exceptions. First, the designation of depositories and the allocation of public funds for these entities is in the hands of specific boards of finance. Second, the law tends to limit the geographic scope with respect to the selection of depositories by the local governments. Specifically, the various boards of finance are required by law to select depositories willing to accept public funds located within their respective counties, cities, towns, or townships. As in the case of the state, the law calls for the proportional allocation of public funds among the designated depositories.

a residual. For example, if the law specifies that public funds may be deposited only in commercial banks within the state, then public officials may select one or a number of banks to hold the deposits, based upon safety, liquidity, and yield. Assuming that all available choices offered equal safety and liquidity, the bank paying the highest yield would be chosen as the depository. Clearly, the more specific the legal guidelines, the smaller will be the residual prerogatives and discretion allowed public officials.

The laws that influence the allocation of public funds vary greatly from state to state

and within the states.⁵ (See Boxes for more detail.) Illinois, for example, is the only Seventh District state that employs a true bidding system by which to allocate state funds. Indiana, on the other hand, does not use a bidding system to allocate state funds; rather, the law calls for the proportional allocation of state funds among those banks which apply to be public depositories. In Michigan the Con-

⁵For a discussion of cash balance management in other states see: *State Cash Balance Management Policy*, Merlin M. Hackbart and R. S. Johnson. The Council of State Governments, Lexington, Kentucky, November 1975.

Iowa depository laws

Chapter 453 of the Iowa Statutes sets forth the major provisions concerning the deposit of the state's public funds. In Iowa there is no bidding system per se that determines the allocation of state funds. In general, all deposits made by the treasurer of state, who may nominate banks to act as depositories, must be in banks in Iowa. For both the state and its political subdivisions funds not needed for current operating expenses may be invested in U.S. Government or agency guaranteed obligations, or time or savings deposits in approved commercial banks and insured savings and loan associations. When state funds are deposited, they must be at the rate established on a monthly basis by a committee composed of the state's superintendent of banking, commissioner of insurance, and treasurer of state. The law does not explicitly limit the amount of state funds that may be placed in any one depository nor is there any requirement for public depositories to pledge assets against

public deposits. Iowa, like Indiana, has an established state sinking fund to insure against the loss of public deposits in the event of a bank failure. As of June 30 1975, the fund's balance was about \$203,000.

As in the case of the state, banks must be approved by the appropriate governing authority before they can act as depositories for Iowa's political subdivisions. The approving board is required to specify the name of each bank approved and the maximum amount that may be kept on deposit in each bank. County funds must be placed in banks located in their respective or adjoining counties, city funds in banks located in the city; but if no bank is in the city, then any other bank located in the state may act as a depository. The interest rate paid for deposits is determined by the public officer or body responsible for the funds and bank; however, the rate cannot exceed nor may it be more than 1 percent below the rate established for state funds.

stitution limits the deposit of state funds to banks organized under state or national banking laws. Savings and loan associations may not act as depositories for state funds. And in Wisconsin an investment board is responsible for designating state public depositories and allocating state funds.⁶ Clearly, there is little uniformity in the Seventh District states relative to those laws which influence and determine the allocation of state and local deposits.

Impact on state banking structure

Legal restrictions on the investment of state and local funds have had an important impact on the banking structure in each of the five states. Table 3 shows the percentage share of total state IPC deposits and state and local deposits held by each of the district states' five largest commercial banks as of June 30, 1975. For example, the largest commercial bank in

Illinois held total IPC deposits of approximately \$8 billion, which represented 16.3 percent of the total IPC deposits held by all commercial banks in Illinois, but its \$395 million in state and local deposits represented only 8.6 percent of such deposits held by all commercial banks in Illinois. In two of the five states (Iowa and Wisconsin), the five largest commercial banks hold a significantly larger proportion of state and local deposits than they do IPC deposits. In Wisconsin, for example, the five largest commercial banks, which control approximately 16.8 percent of total IPC deposits, control 35.4 percent of total state and local deposits. Clearly, this is the result of the interaction between the law allowing for the establishment of a working bank and the Wisconsin Investment Board's selection (after bidding) of the largest commercial bank to act as the sole working bank.

In Indiana the law calling for the proportional allocation of state and county funds among designated public depositories is reflected in the relative shares of public and private deposits held by the five largest commercial banks. The largest commercial bank in Indiana holds approximately 7.3 percent of

⁶For detailed discussion of the Wisconsin investment program see: *Investing State Funds: The Wisconsin Investment Board*, Dick Howard and James Jarrett. The Council of State Governments, Lexington, Kentucky, August 1976.

Michigan depository laws

Michigan is unique, being the only state in the Seventh Federal Reserve District that has a constitutional provision concerning the deposit of public funds. Article 9 of the Michigan Constitution specifies that state funds may not be deposited in any banks other than those established under national and state banking laws. This precludes their deposit in savings and loan associations. Further, the Constitution specifies that deposits of state money cannot exceed 50 percent of the capital and surplus of the depository.

No bidding system for state funds has been established in Michigan. The law merely indicates that state depositories must pay a rate of interest which the state treasurer "shall deem best for the interest of the state." Furthermore, the state treasurer is required to obtain "good and ample security" before a bank can become a depository of state surplus funds. No collateral is required for public monies which are insured by the FDIC. Under current FDIC regulations

time and savings deposits of state and local governments, if deposited in the depositor's own state, are insured up to \$100,000. Public funds in demand accounts and in out-of-state time and savings deposits are insured only to \$40,000. The state prefers to pool its active balances in one bank, which creates certain economies (e.g., ease of record keeping, permits maximum investment of free balances, etc.).

Michigan counties are required by law to solicit sealed bids for the deposit of public funds held by the county treasurer from all banks within their jurisdiction. If no satisfactory bids are received from banks within the county, then bids may be solicited from banks outside the county but within the state. Collateral at least equal to the maximum amount deposited is required from banks holding county funds. No collateral is required for public monies that are insured by the FDIC. Each county may establish its own system of allocating public funds.

total IPC deposits and 7.2 percent of total state and local deposits. In the aggregate Indiana's five largest commercial banks hold about 22 percent of total IPC deposits and about 24 percent of total state and local government deposits, which tends to indicate that the goal of proportional allocation is being achieved.

In Illinois and Michigan the five largest banks in each state tend to hold less than a proportional amount of state and local deposits relative to their holdings of IPC deposits. In Illinois the five largest commercial banks hold approximately 39 percent of total IPC deposits in the state and approximately 26.5 percent of state and local government deposits. Two features in Illinois law tend to explain this less-than-proportional relationship between private and public deposits. First, the five largest banks are precluded from competing for state funds allocated under the Basic Deposit Program. Secondly, the "linked-deposit" allocation schemes used by the state tend to favor small- or medium-sized banks, which have or will make specific state-approved loans. The larger banks tend to be "money

center" banks which derive a significant share of their deposits and make a significant share of their loans on a national or regional basis.

With respect to Michigan, the reason for the less-than-proportional allocation between private and public funds is less clear than it is for Illinois. Part of the explanation may lie in the state's ability and preference for using commercial paper as a short-term investment vehicle relative to certificates of deposit and time accounts. The state, on average, tends to invest about 60 percent of its short-term funds in commercial paper. The requirement that counties keep their funds in county banks might further prevent the flow of public funds to the five largest banks, which are located in but two counties.

Conclusion

The laws that affect the allocation of state and local government deposits within the Seventh District tend to limit the flexibility of the state and local officials who are responsible for the management of public funds and may necessitate a trade-off between various

Wisconsin depository laws

Relative to the other Seventh District states, Wisconsin is unique in that it has a seven-member board responsible for the allocation of state funds. Known as the Investment Board, it is required to "designate public depositories for the deposit of public moneys . . . coming into the hands of the state treasurer; allocate the deposits of all public moneys coming into the hands of the state treasurer, and limit the amount of such public moneys . . . which may be deposited in any public depository so designated." Local government idle funds may also be managed by the Investment Board. Any national, state, or mutual savings bank in the state can act as a public depository.

Recently, the law was amended to allow savings and loan associations to act as depositories of public funds. The Investment Board is responsible for fixing the rates of interest paid on deposits of the state treasurer. There is no statutory limit on the amount of state funds which may be deposited with any one bank. With respect to state funds the depositories selected must be located in Wisconsin.

Under Wisconsin law the Investment Board has the authority to establish "working banks" which hold state deposits ("active deposits") on which checks are drawn to conduct the daily affairs of the state. This system is similar to the active bank concept used by Illinois counties. The working bank is primarily responsible for providing the state with its necessary banking services. Although the law allows the establishment of more than one working bank,

the Investment Board concluded that the efficiencies and potential for higher earnings surrounding the use of one bank outweigh using a number of banks. The working bank is selected on the basis of bids submitted by Wisconsin banks. Due to the amount of work involved in handling the state account and the amount of deposit variability (which may vary from \$2 million to \$100 million on any given day) only a well-staffed and highly computerized bank is able to handle the account.

Chapter 34 of the Wisconsin Statutes states that public depositories are not required to give collateral for public deposits. As in the cases of Indiana and Iowa, Wisconsin has an established state deposit guarantee fund to insure public deposits, thus eliminating the requirement that banks pledge collateral for public deposits.

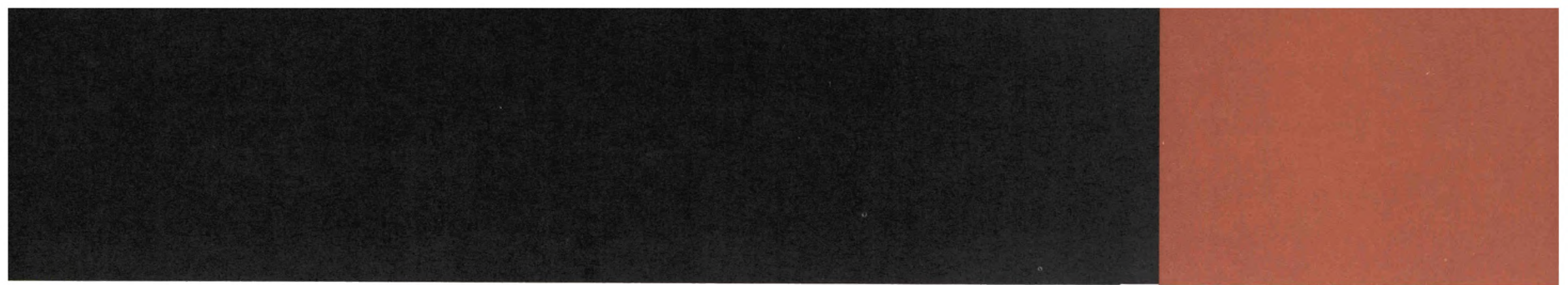
For the most part the requirements of designating and allocating funds of political subdivisions are the same as for the state. One difference is that the designation of public depositories is the responsibility of the governing board of each subdivision—the governing board for counties being the county board, for cities the city council, for villages the village board, and for towns the town board. As in the case of the state, no security is required for subdivision funds. No geographic restrictions are placed on public depositories for subdivision funds other than that the banks designated must be located within the state.

public goals, such as economic development and maximizing the rate of return on idle public funds.

The results of this study reveal that states which tend to stress efficiency in managing state and local funds to achieve maximum returns on invested funds (e.g., Wisconsin) may have to forego certain social goals which may be achieved by allocating idle funds, such as promoting in-state (or in-county) development and statewide bank participation in the use of public funds. If the governmental body decides to select the goal

of maximizing its return on the investment of public funds, then the costs and benefits will be easily measurable in dollar terms. However, if the selected goal involves the achievement of social goals (e.g., promoting development), then the costs and benefits may be more nebulous and harder to define given the fungible nature of money. Since money is a free-flowing object of trade which ignores political boundaries, attempts to use state and local deposits to promote social goals and objectives may be of little avail.

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