FRB CHICAGO ECONOMIC PERSPECTIVES

A review from
the Federal Reserve Bank
of Chicago

MAY / JUNE 1983

Banks and nonbanks: A run for the money

First year experience: Illinois multibanks shop carefully

Bankers' acceptances revisited

ECONOMIC PERSPECTIVES
May-June 1983
Volume VII, Issue 3

Economic Perspectives is published by the Research Department of the Federal Reserve Bank of Chicago. The views expressed are the authors' and do not necessarily reflect the views of the management of the Federal Reserve Bank of Chicago or the Federal Reserve System.

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ISSN 0164-0682

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Banks and nonbanks: A run for the money

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For many years, commercial banks have competed in some product lines with other financial institutions such as S&Ls, mutual savings banks, and credit unions. Recently, commercial banks have increasingly found themselves faced with new competitors—manufacturers such as General Motors Corporation, retailers such as Sears, Roebuck and Company, and diversified financial concerns such as Merrill Lynch and American Express. This new mixed breed of nonbank financial companies and even nonfinancial companies has been encroaching on banks' "turf" over the last decade. And banks, though constrained by regulations, have not willingly shared their traditional business of lending and deposit-taking; rather, they have sought footholds in some of their new competitors' markets.

This article examines the expanded competition in the financial services industry first by quantifying the extent and impact of competition against depository institutions, especially commercial banks, by nonbank companies and then by looking at what depository institutions have done to meet their new competition.

Nonbank Competition—An Historical Overview

Two decades ago the only significant nonfinancial-based firms dealing in financial services were Sears and General Motors with 1962 respective net incomes from financial services of $50.4 million and $40.9 million.[1]

But nonfinancial-based companies have taken a major competitive position in financial services in the past ten years. Such companies have been offering credit and other financial services not as loss leaders to attract additional business, but as profit-making products.[2]

A sample of ten nonfinancial-based companies with impressive earnings from financial services in 1972 is presented in Table 1. During 1972, these companies had net profits from financial activities that totaled $662.2 million. By year-end 1981, their earnings from financial services had reached $1.7 billion, more than 2½ times the 1972 total and certainly more than can be accounted for by inflation. Only two of these companies had lower percentages of earnings attributable to financial services in 1981 than in 1972. The others had higher percentages; in fact, were it not for its finance subsidiary, General Motors would have posted a net loss in 1981.

General Motors and Sears, with 1981 earnings from financial activities of $365 million and $385 million respectively, each had approximately the same financial service earnings as J. P. Morgan & Co., the holding company for the nation's fifth largest bank. Among the nation's largest banking firms, only Citicorp, BankAmerica Corporation, and Chase Manhattan Corporation had earnings that exceeded the financial service earnings of these nonbank giants.

Many of the manufacturers listed in Table 1 originally financed only their own products and therefore did not effectively compete with commercial banks. But by 1972, many of these so-called "captive" finance companies were engaged in financial activities unrelated to the sale of their parents' products.

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[1]Cleveland A. Christophe, *Competition in Financial Services*, New York: First National City Corporation, 1974. In this study of eleven companies, Christophe provides an in-depth view of the relative importance of banks and nonfinancial firms in the extension of consumer credit. Rosenblum and Siegel, *Competition in Financial Services: The Impact of Non-bank Entry* Staff Study 83-1 from which this article is adapted, updates Christophe's work and elaborates upon new competition in other segments of the banking business such as business credit and retail deposits.

[2]As pointed out in "Banking's New Competition: Myths and Realities," *Economic Review*, Federal Reserve Bank of Atlanta, January 1982, pp. 4-11, by William F. Ford, many nonbank firms have sought to enter the product lines of commercial banks because banking appears to be more profitable relative to their traditional lines of business. Yet, despite the entry of these nonbank firms, commercial banks have remained more profitable than their new competitors.

Table 1

Financial service earnings of nonfinancial-based companies (estimated)

	1972		1981	
	Million dollars	Percent of total earnings	Million dollars	Percent of total earnings
Borg-Warner	$6.3	10.6%	$31	18.0%
Control Data	55.6	96.2	50	29.2
Ford Motor	44.1	5.1	186	n.a.[1]
General Electric	41.1	7.8	142	8.6
General Motors	96.4	4.5	365	109.6[2]
Gulf & Western	29.3	42.1	71	24.5
ITT	160.2	33.6	387	57.2
Marcor	9.0	12.4	110	n.a.[1]
Sears	209.0	34.0	385	51.1
Westinghouse	15.2	7.6	34	7.8
	662.2		1,732	

[1]Not available because parent company had a net loss for 1981.

[2]General Motors and consolidated subsidiaries had a loss of $15 million after taxes; however, after adding $348 million of equity in earnings of such nonconsolidated subsidiaries as GMAC, General Motors had after-tax net income of $333 million.

SOURCE: Harvey Rosenblum and Diane Siegel, *Competition in Financial Services: The Impact of Nonbank Entry*, Staff Study 83-1 (Federal Reserve Bank of Chicago, 1983), Table 1, p. 12.

This trend has continued. In 1981, over 90 percent of Borg-Warner Acceptance Corporation's income and assets came from financing *other* companies' products, and less than 1 percent of Westinghouse Credit Corporation's financing volume was related to Westinghouse products. For General Electric Credit Corporation, this trend toward financing non-G.E. products began in the mid-to-late 1960s; by 1972, less than 10 percent of General Electric Credit's receivables represented G.E. products, and in 1981 only about 5 percent of General Electric Credit's financing was for its parent's products.

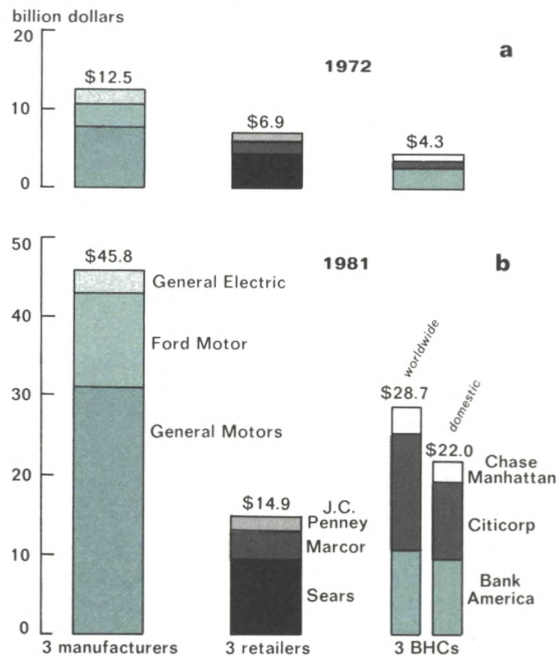
Thus, not only have the earnings from financial activities increased as a percent of total earnings for the majority of the companies listed in Table 1, but many of those companies which were originally captive have evolved to compete increasingly with commercial banks and others in the financial services industry.

Consumer Lending

Over the last decade, some nonfinancial-based companies have made quite remarkable inroads in the area of consumer lending; nonetheless, banks have gained ground in some areas, most notably in credit cards. At year-end 1972, for example, the three largest banks held less consumer installment credit than the three largest nonfood retailers. These, in turn, held less consumer installment credit than three large consumer durable goods manufacturers (see Figure 1a). As shown in Figure 1b, these rankings had changed by year-end 1981. Within this sample of nine companies, bank holding companies experienced the highest growth rate since 1972, in large part due to their credit card operations.

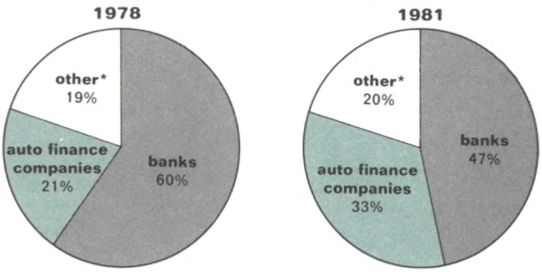
The incursion of nonbank firms in the area of consumer lending is illustrated dramatically in the narrower field of auto loans. As shown in Figure 2, banks have the largest share in auto lending—47 percent at year-end 1981—but this share is down 13 percentage points from its peak

Figure 1
How the big consumer installment credit holders stacked up: 1972 and 1981



SOURCE: Rosenblum and Siegel, Charts 1a and 1b, p. 16.

Figure 2
Car loans: Auto finance companies take a bigger slice of outstanding loans



*Includes credit unions and other finance companies.
SOURCE: Rosenblum and Siegel, Chart 2, p. 22.

in 1978. Over this same three-year period, the share of auto loans held by the captive finance companies of General Motors, Ford, and Chrysler had increased by 12 percentage points to 33 percent of the market. GMAC alone, in 1981, held $28.5 billion of auto loans, almost one-fourth of all auto loans outstanding and double its share of just three years earlier. Bank of America, the largest auto lender among commercial banks, held $2.2 billion of auto loans at year-end 1981, a mere one-thirteenth of the total held by GMAC, far and away the largest consumer lender in the United States and probably the world.

These figures, however, may be somewhat biased by recent events. The soaring cost of funds, binding usury ceilings in many states, and use by General Motors, Ford, and Chrysler of below-market financing rates in an attempt to boost sluggish sales have caused many lenders to exit the auto lending business in recent years.

As shown in Table 2, commercial banks, in 1978, made 58 percent of net new auto loans (new loans extended less liquidations); in 1981, banks' extensions of net auto loans were negative; and in 1982, banks made only 16 percent of the net new auto loans that year. Finance companies, however, made only 25 percent of the net new auto loans in 1978 but accounted for 72 percent of such loans in 1982. The sharp drop-off in new business volume is also particularly noteworthy as it demonstrates a market in a state of flux, a condition conducive to large—even massive—shifts in market shares.

The shift in the consumer lending market away from commercial banks toward finance companies can also be seen in Figure 3. In 1978, commercial banks issued 55 percent of net new installment debt (new loans less liquidations) to households; finance companies accounted for only 22 percent. By 1981, however, these relative shares had more than reversed themselves as commercial banks moved away from consumer installment lending over the 1978-1981 period. In fact, in 1978 commercial banks extended almost $1.20 in new consumer installment credit for every one dollar of consumer installment loans liquidated, but by 1980, they extended only 95 percent for every one dollar of consumer installment loans that were repaid or liquidated. Over this same period, finance companies increasingly entered the consumer lending market; thus, by 1981, finance companies issued 72 percent of net new consumer installment debt while commercial banks issued only 3 percent.

These shifts in market shares may be somewhat distorted by the fact that finance company subsidiaries of bank holding companies are included with finance companies. Further complicating interpretation of the data is the tendency of some banks to sell consumer loans to their finance company affiliates and vice versa. The division between finance companies and banks, however, is correct because banks are regulated very differently than finance companies, regardless of their affiliations.

Also, the shifts in market shares in consumer installment lending are not necessarily permanent but probably reflect cyclical as well

Table 2
Sources of net new automobile credit by holder

	1978		1981		1982	
	Dollar billion	Percent	Dollar billion	Percent	Dollar billion	Percent
Commercial banks	10.9	58	-3.5	*	.8	16
Finance companies	4.7	25	4.0	*	3.5	72
Credit unions	3.1	17	.9	*	.6	12
	18.7	100	8.4	*	4.9	100

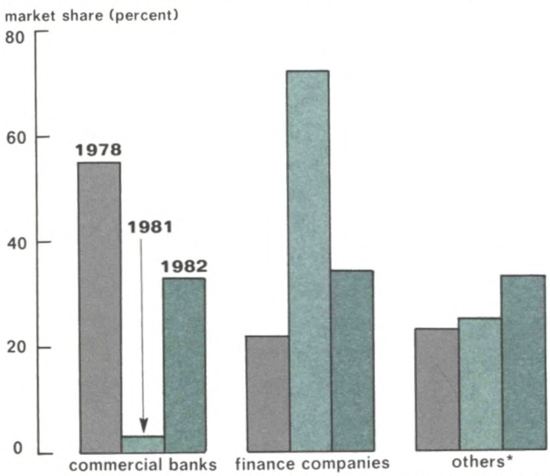
*Percentages not shown because market shares cannot be negative.

SOURCES: U.S. Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin* 69 (May 1982), pp. A42-A43 and *Consumer Installment Credit* G.19 (March 1983).

as secular forces working simultaneously. As can be seen in Figure 3, commercial banks recovered some market share in 1982, as did S&Ls and all other lenders at the expense of finance companies. In fact, finance companies lost almost 38 percentage points in only one year. Furthermore, the comeback of commercial banks and S&Ls in the consumer lending market is likely to continue through 1983 as banks and other depository institutions that have been flooded with new funds in response to the successs of money market deposit accounts (MMDAs), Individual Retirement Accounts (IRAs), and other deregulated deposit instruments become more willing to offer consumer installment loans. Further, S&Ls are likely to maintain a more significant presence in consumer lending than they did in the past as they continue to take advantage of the broader lending powers given them under the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982.

Just as the shift in market share in consumer installment lending has been dramatic, so too has the decline in net *new* loan volume, falling by more than half—to less than $20 billion in 1981 from over $43 billion in 1978. Even more significant was the decline in volume of net new consumer installment loans at commercial banks—down to $0.6 billion in 1981 from $23.6 billion three years earlier. During this same period, auto loans outstanding at commercial banks declined by $2.4 billion; in the prior three-year period (year-end 1978 vs. year-end 1975), auto loans at commercial banks grew by $29 billion.

Figure 3
Consumer loans: banks take a beating



*Includes mutual savings banks, mortgage pools, federal and related agencies, state and local governments, and other lenders.
SOURCES: The Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin* 69 (May 1982), pp. A42-A43 and *Consumer Instalment Credit*, G.19(March 1983).

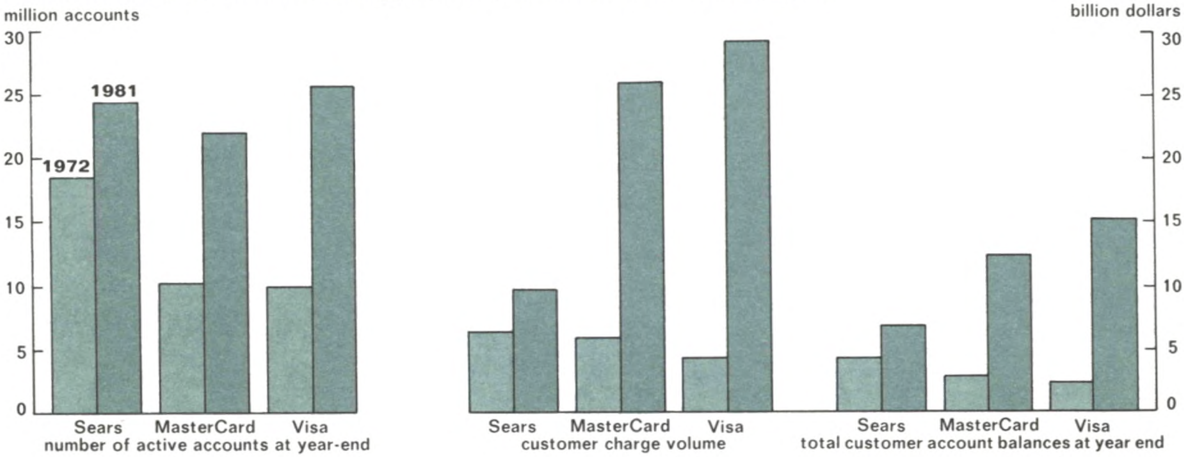
While commercial banks held less in auto loans in 1981 than they held in 1978, their outstanding credit card receivables remained relatively constant at about $17.5 billion over this same three-year period. In fact, it is in the area of charge cards that banks have done best against their nonfinancial-based competitors. In 1972, Sears had the leading credit card in the United States in terms of number of active accounts, charge volume, and customer account balances. By 1981, Visa was the undisputed leader by all three measures with MasterCard not far behind and Sears a distant third except in number of active accounts (see Figure 4). Beginning in 1980 Visa and MasterCard began displacing the cards issued by many retailers such as J. C. Penney and Montgomery Ward.

Whether the success of Visa and MasterCard relative to the Sears card implies a victory for banks over a nonbank competitor is unclear since neither Visa nor MasterCard are banks. They are franchising companies that license a product to franchisees. The original franchisees were banks, but several hundred savings and loan associations, mutual savings banks, and credit unions have become franchisees during the last few years. Indeed, some of Visa's recent growth is attributable to the popularity of Merrill Lynch's Cash Management Account, which includes a Visa card.

Business Lending

Commercial banks remain the predominant source of credit to all businesses, large and small. As can be seen in Table 3, banks have the lion's share of short-term commercial and industrial loans (C&I loans) in the United States. The 15 largest bank holding companies held $141.6 billion of domestic C&I loans at year-end 1981, more than triple the total held by a selected group of 32 nonbank companies, most of whom

Figure 4
The bank cards ace out the biggest retailer on balance and volume



SOURCE: Rosenblum and Siegel, Table 9, p. 23.

have made forays into banks' traditional commercial lending activities.[3]

The importance of nonbank lenders should not be underestimated. With $39.4 billion in C&I loans the 15 selected industrial companies were an important factor in the C&I loan market, holding almost three-tenths as much in loans as were booked domestically by the 15 largest bank holding companies. In addition, funds that large firms raise from banks and from the money and capital markets are used to provide loans to many small businesses. This trade credit, although an imperfect substitute for bank credit because it cannot be used to pay other creditors or meet employee payrolls, is the most widely used source of credit for small businesses, both in terms of the percentage of firms utilizing it and in dollar volume. Moreover, at year-end 1981 nonfinancial firms had $53.7 billion of commercial paper outstanding and nonbank financial firms had $77.4 billion of commercial paper outstanding; some portion of this was used to provide credit to businesses.

Banks are also an important source of funds for commercial mortgages and lease financing, but nonbank firms again should not be overlooked in these areas. As shown in Table 3, four insurance-based companies held more commercial mortgage loans at year-end 1981 than did the 15 largest bank holding companies.[4] The 32 selected nonbank firms also held more lease receivables at that time than did the top 15 bank holding companies on a worldwide basis and more lease receivables than did domestic offices of the nation's more than 14,000 insured commercial banks. If the sum of C&I loans, commercial mortgage loans, and business lease financing can be used as a *rough* proxy for total business credit, then it would appear that the 32 selected nonbanking-based firms have made significant inroads into the commercial lending activities of commercial banks.

Deposit-Taking

Not only are banks experiencing competition from nonbanking-based firms in lending areas, but they are also witnessing the same phenomenon in the area of deposit-taking. Substitutes for bank deposits have been around as long as there has been a reasonably efficient secondary market for government and private securi-

[3]These 32 companies were chosen on the basis of their being the most frequently listed nonbanking-based competitors of commercial banks. Many financial-based companies have been excluded because they have demonstrated little or no inclination to invade the turf of commercial banks.

[4]Insurance companies have played a major role in commercial mortgage lending for many years. Further, many banks do not have the ability to hold long-term commercial mortgages because of the short-term nature of their funds.

Table 3

Business lending by selected nonbanking-based firms and bank holding companies at year-end 1981

	Commercial and Industrial Loans	Commercial Mortgage Loans	Lease Financing	Total Business Lending
	(- - - - - - - - - - - - - - - - -	*$ million*	- - - - - - - - - - - - - - - -)	
15 Industrial/Communications/ Transportation†	39,365	1,768	14,417*	55,550
10 Diversified Financial†	3,602	3,054	1,581*	8,237
4 Insurance-Based	399	35,506	892*	36,797
3 Retail-Based	606	—	—	606
	43,972	40,328	16,890*	101,190
15 Largest BHCs				
Domestic	141,582	19,481	14,279*	175,342
International	118,021	5,046	—	123,067
Total, Top-15 BHCs	259,603	24,527	14,279	298,409
Domestic Offices, All Insured Commercial Banks	327,101	120,333**	13,168	460,602

*Includes domestic and foreign lending and may include leasing to household or government entities.

**Includes all real estate loans except those secured by residential property.

†Financing by banking and savings and loan subsidiaries has been subtracted.

SOURCE: Harvey Rosenblum and Diane Siegel, *Competition in Financial Services: The Impact of Nonbank Entry*, Staff Study 83-1 (Federal Reserve Bank of Chicago, 1983), Table 10, p. 26.

ties. Treasury bills and repurchase agreements, for example, are close substitutes for bank deposits, including demand deposits.

In 1973 a closer substitute for bank deposits emerged—money market mutual funds (MMFs). While not a big threat to banks when interest rates were relatively low, MMFs became very successful when rates rose, growing from only a few billion dollars in "deposits" in 1975 to over $230 billion by December 1982 when they reached their peak. At that time, Merrill Lynch alone managed $50.4 billion in MMF assets, and the Dreyfus Corporation managed $18.5 billion. Originally offered by nonbank financial firms such as Dreyfus and the Fidelity Group, MMFs attracted nonfinancial-based firms as well. Sears began offering the Sears U.S. Government Money Market Trust in late 1981 and later acquired Dean Witter Reynolds, a brokerage firm managing five MMFs.

Although MMFs do compete with bank deposits, few nonbank companies rely to any significant extent upon deposits as a source of funds to finance the loans extended to their customers. Mostly, their funds are raised in the money and capital markets at competitive rates; consequently, the profit margins of most nonbank companies which have financial activities are not, and have never been, dependent upon the Regulation Q franchise. It has been estimated that roughly half of the 1980 profits of 31 of the 50 largest U.S. banks could be attributed to their ability to pay below-market rates on savings accounts.[5] Thus, the continued phase-out of Q-ceilings is unlikely to damage the market position of nondepository firms in lending.

The Banks' Responses to Nonbank Competition

Commercial banks, as well as other depository institutions, have attempted to meet the nonbank challenge by offering some products and services—such as MMFs and discount brokerage services—that had become the domain of nonbank financial firms (see box, chronology 1). In addition, banks and other depository institutions have tried to circumvent regulatory geographic barriers to compete on an even keel with their nonbank rivals (see box, chronology 2).

[5]Alex J. Pollock. "The Future of Banking: a National Market and Its Implications," in *Proceedings of a Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago, 1982, pp. 31-36.

Products and Services

Banks and other depository institutions have not stood idle while deposits left their low-yielding accounts for MMFs. As shown in chronology 1, banks and thrifts have designed various products to compete with MMFs and, at the same time, to skirt a number of competition-inhibiting or cost-raising regulations. The Bank of California, for example, tried to shield an MMF-like account from interest rate ceilings by housing it in Bancal's London branch, and Orbanco proposed a note that would pay market rates and have transaction features. These two schemes were stopped by the Federal Reserve Board, but other innovations have met with more success. Northwestern National Bank, for instance, began allowing its customers to borrow money on their six-month money market certificates through checking accounts in April 1981, and Talman Home, Chicago, introduced its Instant Cash Account in September 1982.

While some depository institutions created products to compete with MMFs, others decided to join them rather than try to beat them. Banks and thrifts began collaborating with money fund managers like Dreyfus and Federated Securities to offer sweep accounts—accounts that sweep idle cash balances exceeding some predetermined level into high-yielding MMFs.

Finally, banks and thrifts no longer had to try to circumvent regulations by linking up with money fund managers in order to offer their customers MMF-like products. In early October 1982, the Congress passed, as part of the Garn-St Germain Depository Institutions Act of 1982, new legislation which permits banks and other depository institutions to offer the Money Market Deposit Account, and in December 1982, the DIDC authorized the Super NOW account. Both are designed to compete directly with MMFs.[6]

[6]Both the MMDA and the Super NOW account require an initial deposit of $2,500, are free of interest rate ceilings, and are federally insured; however, depositors can write only three checks per month on an MMDA whereas they can write an unlimited number of checks on a Super NOW. Super NOW accounts are restricted to individuals, certain non-profit corporations, and governmental units, whereas MMDAs can be offered to any entity.

Another area dominated by nonbank financial firms which banks have sought to enter is discount brokerage services. Generally, banks have taken one of three paths in offering these services: collaborating with discount brokerage firms, acquiring existing brokerage firms, or establishing discount brokerage subsidiaries of their own.

As shown in chronology 1, many banks and thrifts have taken the first route, hooking up with brokers such as Fidelity Brokerage Services and Quick & Reilly. Some, however, have opted for one of the other two routes. For example, Security Pacific National Bank, which at first offered discount brokerage services through Fidelity, acquired Kahn & Company, a Memphis-based discount brokerage, in October 1982. In November 1982, Security Pacific formed a subsidiary to provide back office support for other banks entering the discount brokerage field. More recently, BankAmerica Corporation acquired Charles Schwab & Company, the nation's largest discount broker. Taking the third path, in November 1982, three S&Ls started Invest, a brokerage service which S&Ls nationwide can offer.

In addition, since mid-1981 when J. P. Morgan & Co. formed a subsidiary to trade financial futures for Morgan Guaranty's account, banks have increasingly been seeking to trade in the financial futures market for their own accounts as well as for their customers. Before they can act as brokers for third parties, however, banks must first get approval from the Comptroller of the Currency or, in the case of bank holding companies, from the Federal Reserve Board. Then they must apply to the Commodity Futures Trading Commission (CFTC) for registration as brokers. Among those that have cleared both stages of the regulatory process are J. P. Morgan & Co., North Carolina National Bank, Bankers Trust, and First National Bank of Chicago.

Banks are also expanding into less finance-related fields such as data processing and telecommunications. For example, Citicorp was recently given permission to offer an expanded range of data processing and transmission services[7] and, in June 1982, it purchased two trans-

[7]*Federal Reserve Bulletin*, August 1982, p. 505.

Chronologies of change

1. Banks fight back

Apr 1981 Citibank and Northwestern National Bank allow their customers to borrow money on their six-month money market certificates through a checking account.

May 1981 The Bank of California NA, San Francisco, introduces a new account to compete with money market funds. Because the account is housed in the bank's London branch, BanCal says it is not subject to interest rate ceilings and reserve requirements, but the Fed disagrees.

May 1981 J.P. Morgan & Co. forms a subsidiary to trade financial futures for Morgan Guaranty's account. In July 1981, the Federal Reserve Board allows Morgan Guaranty to execute trades for its customers; in December 1982, the Commodity Futures Trading Commission approves.

Sep 1981 Dreyfus Service Corp. sweeps excess cash from bank accounts into its money market funds, and other firms follow Dreyfus' lead.

Nov 1981 BankAmerica Corp. plans to acquire Charles Schwab & Company, the nation's largest discount brokerage firm; the Federal Reserve Board approves the acquisition early in 1983.

Jan 1982 Banks and thrifts collaborate with brokerage firms to offer discount brokerage services to customers of the banks and thrifts.

Mar 1982 Orbanco Financial Services Corp., a Portland, Oregon, holding company, proposes a note with a minimum denomination of $5,000, which bears market interest rates, and which has transactions features. The Federal Reserve Board, however, disallows the note.

May 1982 Three S&Ls receive permission to start a joint securities brokerage service that S&Ls nationwide can use to offer investment services to their customers. The service, known as Invest, begins operations in November.

Jun 1982 Citicorp purchases two transponders on the Westar V satellite in preparation for global banking.

Jul 1982 The Federal Reserve Board allows Citicorp to offer various data processing and data transmission services nationwide through a new subsidiary, Citishare Corp.

Aug 1982 The Comptroller of the Currency allows First National Bank of Chicago to form a subsidiary to trade in the futures market for its customers. In January 1983, the Commodity Futures Trading Commission approves.

Sep 1982 Talman Home Federal Savings and Loan Association introduces its Instant Cash Account to compete with money market funds. The account requires a $5,000 minimum balance and pays the rate of a 6-month CD.

Sep 1982 North Carolina National Bank's NCNB Futures Corp. receives final approval from the Commodity Futures Trading Commission to act as a futures commission merchant.

Sep 1982 The Federal Reserve Board allows Bankers Trust New York Corp. to buy and sell futures contracts for its customers through a new subsidiary, BT Capital Markets Corp. In January 1983, the Commodity Futures Trading Commission approves.

Sep 1982 Poughkeepsie Savings Bank applies to the FHLBB to acquire Investors Discount Corp., a Poughkeepsie discount brokerage firm.

Oct 1982 The Comptroller of the Currency allows Security Pacific, Los Angeles, to acquire Kahn & Co., a Memphis-based discount brokerage firm.

Oct 1982 The DIDC authorizes an account which federal depository institutions can offer and which is "directly equivalent to and competitive with money market funds."

Nov 1982 Security Pacific National Bank forms a subsidiary, Security Pacific Brokers Inc., to provide back office support for other banks which offer discount brokerage services.

Dec 1982 The DIDC authorizes a Super-NOW account which federal depository institutions can offer on January 5, 1983.

2. Interstate barriers crumble

Mar 1980 South Dakota passes legislation which allows out-of-state bank holding companies to move credit card operations to South Dakota. Three years later, the state passes a new bill that allows out-of-state bank holding companies to own state chartered banks which can own insurance companies.

Feb 1981 Delaware passes an out-of-state banking bill which opens the state to major money center banks.

Jun 1981 Citibank establishes Citibank (South Dakota) NA in Sioux Falls to handle its credit card operations.

Aug 1981 Marine Midland Banks, Inc., Buffalo, New York, infuses $25 million into Industrial Valley Bank and Trust Company, Philadelphia, by buying newly issued common stock and nonvoting preferred stock with warrants to buy an additional 20 percent of Industrial Valley's common stock should interstate banking be permitted.

Sept 1981 United Financial Corp., San Francisco, a subsidiary of National Steel and parent of Citizens Savings and Loan, acquires an S&L in New York and one in Miami Beach. The Combined S&Ls later become First Nationwide Savings.

Nov 1981 Casco-Northern Corp., Portland, Maine, parent of Casco Bank and Trust Company, sells First National Boston Corp. 56,250 shares of its convertible preferred stock and warrants to buy additional common shares. In March 1983, First National Bank of Boston Corp. agrees to acquire Casco-Northern.

Dec 1981 J.P. Morgan & Company establishes Morgan Bank (Delaware), to engage in wholesale commercial banking.

Dec 1981 Home Savings and Loan Association, Los Angeles, acquires one Florida thrift and two in Missouri. In connection with the acquisitions, Home Savings and Loan becomes Home Savings of America.

Jan 1982 North Carolina National Bank Corp. acquires First National Bank of Lake City, Florida, by using a legal loophole in a grandfather clause.

Jan 1982 AmSouth Bancorp. of Alabama, South Carolina National Bank Corp. and Trust Company of Georgia plan to merge into a single holding company if and when interstate banking is permitted. Until then, each is buying $2 million of nonvoting preferred stock in the other two.

Jan 1982 Home Savings of America, Los Angeles, acquires five Texas savings associations and one in Chicago.

Mar 1982 Marine Midland Banks, New York, invests $10 million in Centran Corp., Cleveland, in the form of newly issued nonvoting preferred stock and warrants to buy over 2 million shares of Centran's common stock should interstate banking be permitted.

Jun 1982 Alaska's new banking law permits out-of-state banks to acquire Alaskan banks without the states of those banks enacting reciprocal legislation.

Jul 1982 New York legislation amends the state's banking law to allow out-of-state bank holding companies to acquire control of New York banks provided that the states of these banks reciprocate.

Aug 1982 The Federal Reserve Board and the shareholders of Gulfstream Banks Inc., Boca Raton, Florida, approve the acquisition of Gulfstream Banks by North Carolina National Bank Corp.

Sep 1982 In the first reciprocal interstate bank acquisition between New York and Maine, Key Banks Inc. of Albany agrees to acquire Depositors Corp. of Augusta; the acquisition is expected to be completed by the end of 1983.

Dec 1982 The Federal Reserve Board allows Exchange Bancorp., Florida, to merge into North Carolina National Bank Corp., and the Fed approves the merger of Downtown National Bank of Miami into NCNB/Gulfstream Banks Inc.

Dec 1982 Both houses of the Massachusetts State legislature pass an interstate banking bill which allows Massachusetts banks to expand into other New England states on a reciprocal basis. The law is effective in 1983.

ponders on the Westar V satellite, thus becoming the first financial institution to own transponders in space.

Geographic Barriers

Banks seem to be meeting the challenges of nonbank competition in many of their new rivals' product lines, but banks do not yet enjoy the same geographic freedom as their nonbank competitors. Although many of the products and services which banks and bank holding companies provide are offered nationwide, such as those provided through nonbank subsidiaries like consumer finance and mortgage banking companies, the interstate expansion of a ***bank's*** physical facilities is still generally prohibited. Nonetheless, as shown in chronology 2, banks and thrifts are preparing for the legalization of interstate banking, and—through mergers, acquisitions, affiliations, relaxations of some state laws, and technological advances—interstate banking is slowly becoming a reality.

Agreements to merge are the most common way in which banks and thrifts have been preparing for interstate banking. Usually, one institution agrees to invest in another by purchasing nonvoting preferred stock with warrants to buy additional shares of common stock should interstate banking be allowed. Although Citicorp was the first to use such a maneuver, many others have followed. In this manner, for example, Marine Midland Banks, New York City, invested $25 million in Industrial Valley Bank and Trust Company, Philadelphia, and $10 million in Centran Corporation, Cleveland.[8]

Some interstate mergers and acquisitions, however, have already taken place. In January 1982, Home Savings of America, Los Angeles, acquired five ailing savings associations in Texas and one in Chicago after acquiring a troubled Florida thrift and two in Missouri. Also in January 1982, North Carolina National Bank Corporation acquired First National Bank of Lake City, Florida, through a loophole in a grandfather clause, and later expanded further in that state. Although the acquisitions by Home Federal and those by North Carolina National Bank Corporation are different in nature and purpose, five or ten years from now their effects will be the same.

In some instances, interstate banking has been encouraged by individual states. In early 1980, South Dakota passed a law which allows out-of-state bank holding companies to establish banks to house credit card operations, and in June 1981, Citicorp moved its credit card operations to the newly established Citibank (South Dakota). In March 1983, South Dakota passed another law which allows out-of-state bank holding companies to acquire or charter state banks, which could own insurance companies. Delaware passed its out-of-state banking law in February 1981 to encourage banks to relocate certain activities in the state; since then 12 institutions have established banks in Delaware, including five from New York, four from Maryland, and three from Pennsylvania. However, these new banks do not compete with Delaware banks in general banking operations. In June 1982, Alaska enacted legislation that allows out-of-state banks to acquire Alaskan banks without reciprocal legislation on the part of the states of those banks. New York, Massachusetts, and Maine enacted similar legislation but require reciprocity. Out-of-state banks, therefore, can compete with banks in Alaska, New York, Massachusetts, and Maine, but Massachusetts limits interstate banking to the New England states.

Interstate banking also occurs through banks' and thrifts' affiliations with nationwide brokers and investment firms. Alliances that would have been termed "unholy" not long ago are commonplace today. Through its network of some 475 offices, Merrill Lynch has marketed All Savers Certificates for Bank of America, Crocker National Bank, and two S&Ls, one in Florida and the other in Washington. Merrill Lynch also maintains a secondary market for retail CDs issued by banks and S&Ls and acts as a broker in the placement of retail CDs issued by more than 20 banks and thrifts, thus giving each of them a nationwide reach. Merrill Lynch is not alone in this regard but is joined by several other com-

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[8]The Federal Reserve Board permits these limited interstate banking activities if the acquiring company holds no more than 24.9 percent of the nonvoting shares, holds no more than 5 percent of the voting stock, and exercises no control over the bank in which the investment is being made.

panies including Sears/Dean Witter, Shearson/American Express, and E. F. Hutton. Together these four firms operate roughly 1,325 offices throughout the United States. Thanks to these and other firms like them, a comparatively small depository institution such as City Federal Savings and Loan of Elizabeth, New Jersey, can now compete toe-to-toe on a nationwide basis with Bank of America in the sale of federally insured retail CDs.

The importance of the cooperative affiliations between brokers and depository institutions should not be underestimated, for it may represent one of the most significant reductions in entry barriers into the financial services business. No longer is deposit and loan growth of a de novo bank or S&L constrained by its ability to generate deposits from its local customers. To the extent that it has profitable lending opportunities, a new depository institution can engage in liability management through the sale of brokered, insured *retail* deposits by paying above the going market rate. The availability of federal deposit insurance should make depositors virtually indifferent to the identity of the institution they deal with. It is now conceivable that a de novo bank or S&L could develop a billion-dollar deposit base within a year or two of its opening.

Conclusion

Over the last decade, competition in financial services has increased as the number of firms grew and the geographic market became more and more national. Furthermore, deregulation tends to be accompanied by unbundling of products, and this has been the case in the financial services industry. Nonbank firms have been able to target and successfully enter the major and minor product lines of commercial banks. Thus the preeminent position of commercial banks has been eroded somewhat in consumer lending, business lending, and deposit-taking. But as nonbank rivals encroached upon banks' traditional territory, banks responded where possible by invading some of their new competitors' product lines and by attempting to compete on a nationwide basis as do these competitors.

Thus, by 1983, the line of commerce that was once called commercial banking has evolved into a new line of commerce, the provision of financial intermediation services. Yet, the courts have continued to delineate commercial banking as a distinct line of commerce, separate from other financial services. In the eyes of the courts, banks compete only with other banks, but not with S&Ls, credit unions, finance companies, mutual savings banks, insurance companies, and so forth. This has been the prevailing view of the courts for two decades, having been decided in *Philadelphia National Bank*[9] in 1963.

The evidence provided in this article illustrates quite clearly that technological advances and long overdue statutory and regulatory changes have blurred the distinctions between financial intermediation services offered by old-line, traditional financial institutions such as banks and S&Ls and the services offered by the financing arms of manufacturers, retailers, and diversified financial conglomerates. In the longer run, the survivors will be the low cost producers—irrespective of their charters. Perhaps then the line of commerce definition will be judicially or legislatively revised.

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[9]*United States* v. *The Philadelphia National Bank* et al., 374 U.S. 321, 915 (1963).

This article is a brief summary of a more detailed monograph, *Competition in Financial Services: The Impact of Nonbank Entry*, by Harvey Rosenblum and Diane Siegel, Staff Study 83-1.

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First year experience: Illinois multibanks shop carefully

Sue F. Gregorash

Many independent bankers in Illinois thought that their worst fears were being realized when Governor James Thompson signed the multibank holding company bill (Public Act 82-1) into law on July 3, 1981. For years, these independent bankers had battled multibank banking proponents, even to the point of splintering one statewide banking trade group, to protect independent unit banking and avert the perceived threat of being swallowed up by the big Chicago banks. But, in the first year after the bill became effective on January 1, 1982, Illinois' bank holding companies (BHCs) did not deluge regulators with holding company applications. The changes in the Illinois banking industry have been, so far, orderly and evolutionary. The trade groups have mended their fences and reunited.

Provisions of the act

Illinois law imposes several restrictions, some of which are peculiar to the state, on prospective multibank holding companies. First of all, it is noteworthy that Illinois does not allow branch banking; the 1981 law did not change that fact, save for the additional limited "community service facility"[1] allowance. The law divided the state into five bank holding company regions (see box). Region I consists of Cook County, where the Chicago area's major banks are located. Region II includes the five counties surrounding Region I, appropriately called the "collar counties." Regions III, IV, and V group the counties of northern, central, and southern Illinois, respectively.

Holding companies are restricted to acquiring banks in their designated region and one *contiguous* region. For instance, BHCs located in Region IV can acquire banks in that region, as well as in Region III or Region V, but not both. "Designated region" is defined in the law to be the banking region of the holding company's largest subsidiary bank (in terms of total assets). Once a BHC has indicated a preference for a contiguous region via an acquisition, it is precluded from acquiring banks in any other contiguous region.

Region I has only one contiguous region, i.e., the collar counties around Cook County. (Region V is similar in this respect.) This design intentionally prevents the big Chicago banks from acquiring downstate Illinois banks and severely limits Chicago BHCs' geographic expansion capabilities within the state.

The new law also prohibits BHCs from acquiring a bank chartered after January 1, 1982, until the bank has been in business for at least ten years.[2] This provision was incorporated into the law to prevent the state's larger holding companies from saturating the state with de novo banks.

A BHC located outside of Illinois can acquire an Illinois bank only if it owned at least two banks in Illinois prior to the effective date. This section was added to the law to grandfather one particular preexisting holding company relationship and to limit entry into Illinois by out-of-state BHCs. The new law has no provision for reciprocal interstate bank holding company acquisitions.

Finally, the bill allows each bank to establish a third "community service facility." These facilities can be established either within the home county or within ten miles of the bank's home office location.

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[1]Community service facilities offer fewer services than a full-service branch. They are limited to receiving deposits, cashing and issuing checks, drafts, and money orders, changing money, and receiving payments on existing indebtedness. Banks were permitted by previous law to establish a maximum of two facilities.

[2]An amendment to the law, effective June 23, 1982, exempts from the 10-year requirement failing banks and banks chartered solely as a vehicle for reorganization.

Banking in Illinois prior to the multibank act

At year-end 1981, Illinois, after Texas, was the state with the largest number of commercial banks—more than 1,300. In fact, 8.8 percent of all commercial banks in the United States are in Illinois. This large number is due primarily to the absence of branch banking in the state.

With such a large number of commercial

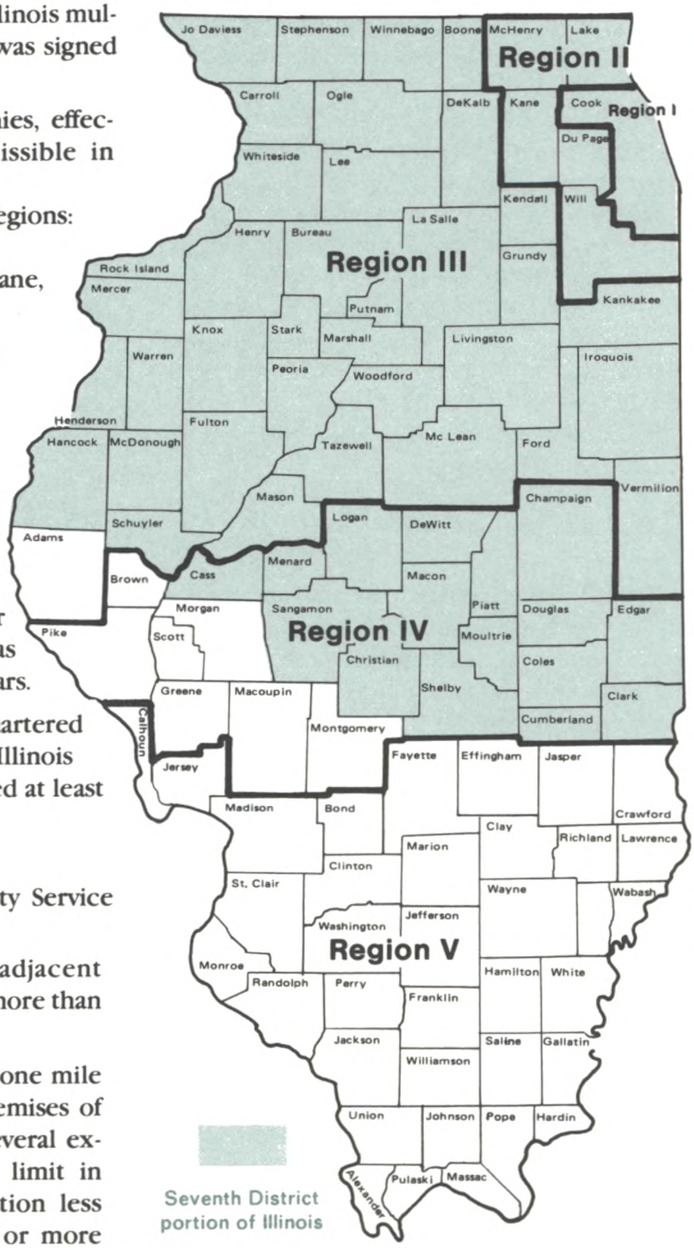
Illinois' new bank marketplace

The major provisions of the Illinois multibank holding company act that was signed July 3, 1981 include:

- Multibank holding companies, effective January 1, 1982, are permissible in Illinois.
- The state is divided into 5 regions:
  Region I: Cook County
  Region II: McHenry, Lake, Kane, DuPage and Will Counties
  Region III: Northern Illinois
  Region IV: Central Illinois
  Region V: Southern Illinois
- Holding companies may be formed and may acquire banks in no more than two contiguous banking regions.
- No holding company may acquire a bank chartered after the effective date until the bank has been in business for at least 10 years.
- Holding companies headquartered outside of Illinois may acquire an Illinois bank *only* if the corporation owned at least two banks in Illinois *prior* to the effective date.
- Allows for one "Community Service facility"

  Within home county or adjacent county (if in adjacent—not more than 10 miles from main bank).

  Facility cannot be less than one mile from existing main bank premises of another bank—subject to several exemptions (e.g., a two-mile limit in municipalities with population less than 10,000 which have 3 or more banks).



banks there exists a large supply of potential candidates from which to form multibank holding company groups. Table 1 shows bank distribution and deposit size in each of the bank holding company regions. By far the largest concentration of deposits—65 percent of all domestic deposits held by banks in Illinois—is in Cook County. On the other hand, the data show a much more even distribution of banks throughout the remainder of the state, with the largest concentration—30.8 percent—located in Region III.

Multibank activity in 1982

During 1982, 33 multibank holding company applications were filed with the Federal Reserve Bank of Chicago. Twenty-four of these applications, involving 47 banks, were approved and consummated in the first year under the new act (see Table 2). The remaining nine applications were approved, but had not yet been consummated.

Most of the holding company activity occurred in the northern and northeastern portions of the state. Regions I and III were the most active in 1982, with 42 percent of the acquiring BHCs located in Region I, and 29 percent in Region III. Forty percent of the acquired banks are located in Region III, including the seven banks acquired by United Bancorporation, Inc., of Rockford, the largest holding company (in number of banks) formed in 1982.

Although more than fifty percent of the state's banks are located outside a standard metropolitan statistical area (SMSA), only 19 percent of those acquired in 1982 (9 banks) are located outside an SMSA, indicating a preference, at this stage, for banks in metropolitan areas.

Many of the early applications formalized what may be best considered de facto multibank arrangements. For example, three applications, encompassing 18 acquired banks, involved preexisting chain banking relationships. Chain banking is defined as the control of two or more commercial banks by the same individual or group of individuals. Prior to the Illinois multibank act, chain banking had been the market's response to the prohibition against branching

Table 1

Illinois banks and deposits by region
December 31, 1981

	Commercial banks		Total deposits	
	Number	Percent	Amount ($ billion)	Percent
Region I	313	23.8	$59.3	64.9
Region II	161	12.2	7.1	7.8
Region III	408	30.8	11.9	13.0
Region IV	212	16.0	6.2	6.8
Region V	229	17.3	6.8	7.4
State totals	1,323	100.0	$91.4	100.0

SOURCE: Reports of Condition, 12/31/81.

Note: Columns may not add to total due to rounding.

and multibank holding companies in Illinois.

In addition, eight of the 47 banks acquired had some other tie to the acquiring holding company. Some had previously been affiliated with the other banks in the holding company. Others had principals (officers or directors) in common; or the BHC held 5 percent or less of their stock. Four banks had a previous correspondent relationship with the lead bank of the acquiring holding company and two out-of-state banks were acquired under a grandfather provision in Florida's banking law. Only 15 out of the 47 banks acquired did not have a previous relationship with the acquiring BHC.[3]

First-year BHC activity in Illinois has been similar to, though somewhat more active than, early multibank experience in other states. Of these, the multibank state most structurally similar to Illinois is Texas. Like Illinois, Texas is a state with many commercial banks; they are prohibited by state law from branching; and several chain banking relationships had been established in the state.[4] The 1970s was a decade of

[3]Five of these banks were acquired by either Continental Illinois Corporation, Harris Bankcorp, Inc., or Northern Trust Corporation and had previous respondent relationships with the lead banks of these holding companies; however, the importance of these prior relationships may be discounted somewhat due to the great number of respondents serviced by these large correspondent banks.

[4]It should be noted, too, that structural differences exist between the two states in population and deposit growth, income levels, and geographic and institutional concentration of deposits.

BHC expansion in Texas. There were four multibank holding companies in existence in Texas at the beginning of 1971, increasing to nine by the year's end, holding 14 percent of statewide deposits.[5] Illinois, by comparison, had 24 multibank holding companies after the first year, representing approximately 28 percent of statewide commercial bank domestic deposits. Thus, Illinois BHCs hold approximately twice the percentage of statewide commercial bank deposits than did Texas after its first year of active multibank expansion.

[5]John R. Stodden, "Multibank Holding Companies—Development in Texas Changes in Recent Years," *Business Review* (Federal Reserve Bank of Dallas, December 1974), p. 4.

Means of acquisition

Two basic forms of acquisitions—cash purchase and exchange of shares—are employed in bank holding company acquisitions. Sellers who receive cash or notes, under certain circumstances, are required to pay capital gains taxes. Thus, if cash and/or notes are received, installment reporting is frequently used and taxes are paid as the cash is received. On the other hand, exchanges of shares can be structured so that selling shareholders receive multibank holding company stock (either common or preferred) without having to recognize any economic gain. Such gains are postponed until the stock is sold. This form of acquisition is generally referred to

Shopping hints: bank value and price

Book values are used in Table 2 to compare acquisition prices because of ease of calculation and because they seem to be the common denominator used by bankers in discussing acquisitions. However, the limitations of using book value as a measure of value should be recognized. First, book value is based on historical figures and does not consider the "going concern" value of the firm. Second, book values are even more distorted during inflationary times when the market value of bank assets (in particular bonds and mortgages) are depressed. In addition, this effect complicates accounting for goodwill and the valuation reserves resulting from the purchase.

Financial theory suggests that a more appropriate means of calculating a bank's worth is to determine the present value of the future earnings of the bank. This may be done by projecting the bank's earnings per share into the future, determining the present value, and comparing this figure to the bank's current stock price. If the present value is greater than the current stock price, the acquisition is worthwhile. Traditionally, the discount rate used is the cost of capital; however, others have suggested that the planned rate of return on common equity is more appropriate for bank acquisitions.*

None of the Illinois multibank applications received in 1982 indicated that they used the present value method to determine the offer premium. Nor do we have information to tell us whether or not the acquired banks evaluated their offers based on this method. Some are reluctant to use the present value method because of the conjectural nature of the projections, as well as lack of a current stock price or sufficient depth of market for small or closely-held institutions with inactively traded stocks. In fact, some bank stock analysts feel that shares of a bank that represent a control block are worth more than other shares of the same bank,** further complicating the present value calculation.

*Jerome C. Darnell, "How Much is Your Bank Worth?" *Commercial West*, June 14, 1975, pp. 6-12.

**Larry G. Meeker and O. Maurice Joy. "Price Premiums for Controlling Shares of Closely Held Stock," *Journal of Business*, Vol. 53, no. 3, pt. 1 (July 1980), pp. 297-314.

Table 2

1982 Illinois multibank holding company formations and acquisitions (Seventh District portion)

Holding Company Bank(s) Acquired	12-31-81 total deposits* ($ million)	Illinois BHC Region	Located in SMSA (Yes - No)	Date of Consummation	12-31-81 ROA**	12-31-81 ROE**	Cash offer or exchange of shares	Ratio of price to book value† (1.0 = book value)
1. First Colonial Bankshares Corporation, Chicago	165.6	1	Yes					
All American Bank of Chicago (10% additional shares)	28.1	1	Yes	3-26-82	0.82	10.84	cash	1.46
2. Northern Trust Corporation, Chicago	3,200.2	1	Yes					
Security Trust Company of Sarasota, N.A., Sarasota, Florida	N/A	N/A	N/A	4-5-82	N/A	N/A	N/A	N/A
O'Hare International Bank, Chicago	129.9	1	Yes	5-17-82	1.05	13.46	cash	1.61
The First Bank, Naperville	14.2	2	Yes	10-1-82	0.66	9.04	cash	1.98
Northern Trust Bank of Florida, N.A., Miami, Florida	N/A	N/A	N/A	11-1-82	N/A	N/A	N/A	N/A
3. Madison Financial Corporation, Chicago	84.8	1	Yes					
First National Bank of Wheeling, Wheeling	16.0	1	Yes	4-19-82	1.00	23.62	exchange	1.30
Madison National Bank of Niles, Niles	107.8	1	Yes	4-19-82	-0.65	—	exchange	1.68
4. Commercial National Corporation, Peoria	321.0	3	Yes					
Prospect National Bank of Peoria, Peoria	45.8	3	Yes	4-20-82	0.92	11.16	exchange	0.60
University National Bank of Peoria, Peoria	43.4	3	Yes	4-20-82	0.39	5.10	exchange	0.52
5. First Freeport Corporation, Freeport	100.1	3	No					
The Polo National Bank, Polo	22.9	3	No	5-3-82	1.53	16.72	combination, primarily exchange	1.65 (exchange portion)
6. Gary-Wheaton Corporation, Wheaton	172.4	2	Yes					
Batavia Bank, Batavia	32.9	2	Yes	6-17-82	0.75	12.26	exchange	1.02
7. Steel City Bancorporation, Chicago	50.8	1	Yes					
Thornridge State Bank, South Holland	18.8	1	Yes	6-23-82	0.85	10.06	cash	1.46
8. Charleston Bancorp, Inc., Springfield	N/A	4	Yes					
The Bank of Charleston, Charleston	12.6	4	No	6-25-82	0.66	8.51	N/A	N/A
Farmers State Bank of Fulton County, Lewistown (Both acquired under emergency provisions)	28.3	3	No	6-25-82	0.50	7.57	N/A	N/A
9. North Shore Capital Corporation, Wilmette	154.5	1	Yes					
The Morton Grove Bank, Morton Grove	26.7	1	Yes	6-30-82	0.18	3.49	exchange	1.03
10. MPS Bancorp, Inc., Mount Prospect	249.4	1	Yes					
Tollway-Arlington National Bank of Arlington Heights, Arlington Heights	26.8	1	Yes	7-23-82	-0.23	-4.99	cash	1.41
11. Marine Bancorp, Inc., Springfield	451.2	4	Yes					
American National Bank of Champaign, Champaign	52.1	4	Yes	7-30-82	1.12	16.12	choice of cash or notes	0.44 (cash portion)
12. Harris Bankcorp, Inc., Chicago	3,499.5	1	Yes					
Argo State Bank, Summit	42.1	1	Yes	8-4-82	1.48	18.75	cash	1.00
Roselle State Bank and Trust Company, Roselle	111.7	2	Yes	10-1-82	0.59	9.90	cash	1.41

Table 2 (continued)

1982 Illinois multibank holding company formations and acquisitions (Seventh District portion)

Holding Company Bank(s) Acquired	12-31-81 total deposits* ($ million)	Illinois BHC Region	Located in SMSA (Yes - No)	Date of Consummation	12-31-81 ROA**	12-31-81 ROE**	Cash offer or exchange of shares	Ratio of price to book value† (1.0 = book value)
13. Continental Illinois Corp., Chicago	14,966.6	1	Yes					
Continental Bank of Buffalo Grove, N.A., Buffalo Grove	29.7	1	Yes	7-28-82	0.84	10.35	cash	2.62
Continental Bank of Oakbrook Terrace, Oakbrook Terrace	18.5	2	Yes	9-8-82	0.78	9.33	cash	1.65
14. Northwest Funding Co., Inc., Rockford	N/A	3	Yes					
Northwest Bank of Winnebago County, Rockford (de novo)	N/A	3	Yes	7-30-82	N/A	N/A	N/A	N/A
15. Suburban Bancorp, Inc., Palatine	N/A	1	Yes					
Palatine National Bank, Palatine	43.8	1	Yes	7-31-82	0.69	9.09	exchange	N/A, pre-existing chain
Suburban National Bank of Palatine, Palatine	11.5	1	Yes	7-31-82	1.17	11.99	exchange	
Suburban Bank of Cary-Grove, Cary	24.0	2	Yes	7-31-82	0.85	9.65	exchange	
Suburban Bank of Hoffman-Schaumburg, Schaumburg	16.1	1	Yes	7-31-82	-0.16	-1.55	exchange	
Suburban Bank of Rolling Meadows, Rolling Meadows	30.5	1	Yes	7-31-82	2.15	24.79	exchange	
Suburban National Bank of Elk Grove Village, Elk Grove Village	15.1	1	Yes	7-31-82	0.29	3.06	exchange	
Suburban National Bank of Woodfield, Schaumburg	10.6	1	Yes	7-31-82	1.06	11.97	exchange	
16. First Community Bancorp, Inc., Rockford	N/A	3	Yes					
First National Bank & Trust Company of Rockford, Rockford	220.8	3	Yes	8-2-82	0.70	6.81	exchange	N/A, pre-existing chain
North Towne National Bank of Rockford, Rockford	26.4	3	Yes	8-2-82	0.95	13.53	exchange	
First Bank of Roscoe, Roscoe	8.8	3	Yes	8-2-82	0.93	7.70	exchange	
First Bank of Loves Park, Loves Park	12.5	3	Yes	8-2-82	0.81	8.54	exchange	
17. Transworld Corp., Lake Forest	11.6	2	Yes					
Dempster Plaza State Bank, Niles (33%)	21.7	1	Yes	9-3-82	-1.52	—	cash	0.50
18. First Busey Corporation, Urbana	127.7	4	Yes					
Roberts State Bank, Roberts	16.0	3	No	9-17-82	1.43	12.97	cash	1.24
19. Mt. Zion Bancorp, Inc., Mt. Zion	N/A	4	Yes					
The Hight State Bank, Dalton City	6.3	4	No	10-1-82	2.16	21.83	combination, primarily cash	1.61 (cash portion)
20. United Bancorporation, Inc., Rockford	N/A	3	Yes					
United Bank of Rochelle, Rochelle	8.9	3	No	10-31-82	0.84	5.86	exchange	N/A, pre-existing chain
United Bank of Rockford, Rockford	13.4	3	Yes	10-31-82	2.06	24.96	exchange	
United Bank of Ogle County N.A., Oregon	26.8	3	No	10-31-82	0.84	13.16	exchange	
United Bank of Loves Park, Loves Park	61.1	3	Yes	10-31-82	1.51	20.04	exchange	
United Bank of Southgate, Rockford	23.9	3	Yes	10-31-82	0.62	8.94	exchange	
United Bank of Belvidere, Belvidere	39.2	3	Yes	10-31-82	0.86	10.07	exchange	
United Bank of Illinois, N.A., Rockford	106.6	3	Yes	10-31-82	0.89	8.21	exchange	

Table 2 (continued)

1982 Illinois multibank holding company formations and acquisitions (Seventh District portion)

Holding Company Bank(s) Acquired	12-31-81 total deposits* ($ million)	Illinois BHC Region	Located in SMSA (Yes - No)	Date of Consummation	12-31-81 ROA**	12-31-81 ROE**	Cash offer or exchange of shares	Ratio of price to book value† (1.0 = book value)
21. McLean County Bancshares, Inc., Bloomington	N/A	3	Yes					
McLean County Bank, Bloomington	78.7	3	Yes	10-30-82	1.13	18.37	exchange	1.00
Stanford State Bank, Stanford	5.0	3	Yes	10-30-82	2.24	15.13	cash	1.24
22. Central of Illinois Inc., Sterling	N/A	3	Yes					
Citizens State Bank of Mount Morris, Mount Morris	19.4	3	No	12-1-82	2.25	20.08	cash	1.50
23. Mid-Central Bancshares Corporation, Charleston	N/A	4	No					
Ashmore State Bank, Ashmore	5.6	4	No	12-3-82	1.68	15.43	cash	1.50
24. Oak Park Bancorp, Inc, Oak Park	239.9	1	Yes					
The Dunham Bank, St. Charles	15.4	2	Yes	12-24-82	0.82	10.73	choice of cash or combination	2.11 (cash portion)

*Deposit data from Reports of Condition, December 31, 1981.

**ROA and ROE data from Sheshunoff and Company, Inc., *The Banks of Illinois 1982*.

†A simple, unadjusted method was used here for calculating book value premiums. The bank's net worth, as provided in the financial statements of each application, was divided by total common shares outstanding. This value was compared with the cash offer, or in the case of an exchange of shares, with a similar net worth/outstanding shares ratio for the holding company, also taking into account the exchange ratio. Some agreements calculated an "adjusted book value," usually adjusted to reflect the current credit worthiness of the bank's loan portfolio. Therefore, book values and premiums calculated here may differ from those stated in the actual merger agreement.

as a tax-free reorganization. Because of the tax consequences, cash offers are usually higher (i.e., the premium over book value is greater) than those for share exchanges.

Approximately one third of the banks were acquired by means of a cash purchase. Cash offers ranged anywhere from a low of one-half of book value to a high of 2.62 times book, with the average being 1.46 times book. At least one holding company provided the option of either a lump sum or an annuity distribution.

The majority of bank acquisitions in Illinois in the first year were structured around an exchange of shares. Exchanges of bank shares for holding company shares averaged 1.11 times book, ranging from 60 percent of book to 1.68 times book value.[6] All of the holding companies formed by chain banks involved exchanges of shares.

Most of the banks commanding high acquisition premiums were above average in profitability, and were not previously related or affiliated with the acquiring BHC except for, occasionally, a correspondent relationship with the BHC's lead bank. The majority of the premium-priced banks are located in Regions I and II in the Chicago banking market.

There are various explanations why a bank would command a premium in a crowded market with so many alternatives. (The Chicago banking market, defined as Cook, DuPage, and Lake Counties, contained 370 banks at 12/31/81.)[7] At least three are plausible. First, a suburban bank in an attractive high-income and fast growth area might be exceptionally attractive to a BHC.

Second, given Illinois' prohibition against branch banking, the BHC may be looking for location only—in essence de facto branches—

[6]These ratios are comparable to those presented for recent acquisitions in New Jersey, Pennsylvania, and Massachusetts, where typical offerings were 1.6 times book value for cash offers and 1.2 times book value for exchanges of shares. (See Paul S. Nadler, "Bank Acquisitions Seen From Both Sides," *Bankers Monthly Magazine*, September 15, 1982, p. 9). Also, in the second quarter of 1982, the weighted average price to book value for BHC applications received by the Federal Reserve was 1.4 times. This figure is based on offers in the form of cash, notes, exchanges of stock, or combinations. (See "Merger, Acquisition Premiums Figured," *Banking Expansion Reporter*, Vol. 1, No. 19, October 18, 1982, p. 8.)

[7]See 67 *Federal Reserve Bulletin* 727 (September 1981).

and thus purchases one of the smallest banks available. Under this approach the acquiring holding company is less concerned with the acquired bank's overall contribution to earnings.[8]

A third reason cited by large BHCs for their interest in acquiring small banks is their concern over the Federal Reserve Board's reaction to possible anticompetitive effects of the acquisitions. In addition to the BHC's own financial and managerial considerations, the acquiring bank must take into account the BHC Act of 1956 which prohibits the Board from approving any acquisition or merger whose effect may be "substantially to lessen competition."

Future Trends

What implications does the Illinois multibank holding company act have for the future of bank structure in the state? One impact is increased commercial bank concentration, both statewide and in local banking markets. But, on a statewide basis the trend toward increased concentration did not develop in 1982. In fact, just the opposite occurred. The shares of commercial bank domestic deposits held by the state's fifteen largest banking organizations decreased from December 1981 to June 1982. At December 31, 1981, these fifteen organizations held 44.7 percent of statewide deposits, and by June 30, 1982, they held 44.2 percent. During this six month period three of these organizations became multibank holding companies. The decrease in concentration is due primarily to decreasing deposit levels in the state's five largest banking organizations in comparison with the rest of the state. With 1,323 commercial banks in Illinois at the end of 1981, it will be some time before statewide concentration levels begin to show significant increases.

Several applications in process at year-end 1982 are formalizations of pre-existing chain banking relationships, including the Midwest Associated Banks of America group,[9] a chain of 20 commercial banks in Regions II and III, which became the largest multibank formation in the nation to date. Similar applications involving other chains will no doubt be submitted in the future.

Several of the multibank holding companies established during 1982 are continuing to expand. First Busey Corporation, Urbana; Commercial National Corporation, Peoria; and Northern Trust Corporation, Chicago, have had applications approved to acquire a total of five additional banks, but these were not consummated in 1982. In addition, First Community Bancorp, Rockford; Steel City Bancorporation, Chicago; First Freeport Corporation, Freeport; and Suburban Bancorp, Palatine, all had applications accepted for processing by the Federal Reserve Bank of Chicago during the latter part of 1982 that had not been acted upon by year-end.

Certain early acquisitions of suburban banks lead to the conclusion that, as has happened in other states, the multibank law is being used as a de facto branching strategy. A question remains as to whether the Illinois multibank holding company act is merely the wedge being used to liberalize the attitudes of Illinois bankers and the public, to be followed by a more liberal branching law proposal.

Bankers had, literally, years to prepare themselves for the eventual passage of the bill which was lobbied for (and against) so strongly. Why haven't more applications been filed? With the midwestern economy suffering from the worst economic downturn since the Depression, many bankers in Illinois were forced to postpone their acquisition plans. Some of the early acquisitions that involved high-priced offers caused other hopeful marriage partners to price themselves out of the market.

The net effect of the act, based on first year experience, appears to be minimal. However, with declining interest rates and the expanding familiarity with the Illinois law, multibank holding companies and their subsidiaries will become significant forces in Illinois in the future.

[8]Douglas H. Ginsberg, "Bank Holding Company Expansion Strategies: The Illinois Bank Holding Company Act," *Banking Law Journal*, Vol. 99, no. 7 (August 1982), pp. 600-601.

[9]See application by First Midwest Bancorp, Inc., Joliet, Illinois, to acquire 20 banks in Illinois, approved by the Board of Governors on February 28, 1983. Although the application involved 20 banks, the actual chain includes 26 banks.

Bankers' acceptances revisited

Jack L. Hervey

The ten-fold increase in world trade over the past twelve years, to more than $1.8 trillion in exports in 1982, has been accompanied by the rapid growth of short-term credit to finance the international movement of goods. The U.S. bankers' acceptance market has played an important part in providing this expansion in credit financing for both U.S. and worldwide trade.

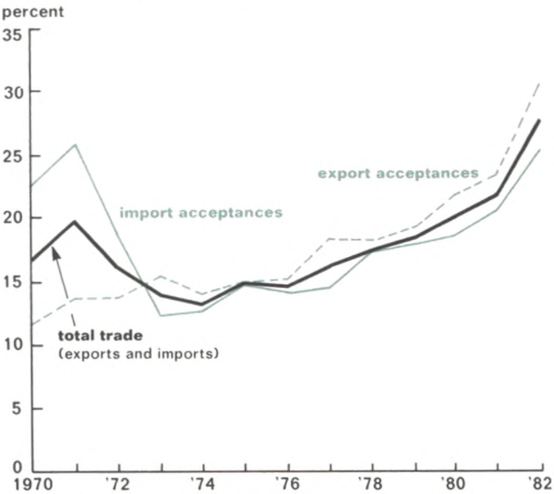
An estimated 17 percent of the total U.S. export-import trade in 1970 was financed in the bankers' acceptance market (see Figure 1).[1] By 1974 only 13 percent of U.S. export-import trade was financed through acceptances. This downward trend was reversed in the last half of the 1970s when both export and import acceptances expanded rapidly. The portion of U.S. trade financed by acceptances increased to about 22 percent by 1981. The proportion expanded further in 1982—to 28 percent—as a result of a continued expansion in the acceptance market that occurred at the same time that exports and imports were contracting.

International trade credit is particularly important because of the often lengthy time between shipment by the exporter and delivery to the importer. In some cases, the importer prepays prior to shipment of the goods; in others, the exporter extends credit on "open account" until delivery. Often, however, the transaction involves a third party who agrees to pay the exporter upon shipment and to receive payment from the importer at some agreed upon future date.

For this credit service, the third party receives the principal and an interest return plus a fee, or commission, associated with the services provided, including the risk of nonpayment by the importer. Open account credit continues as an important component of trade financing, especially when trading partners are well known to each other and the risk of nonperformance is low. However, when the transaction involves a relatively high degree of risk, such as when buyer and seller are not well known to each other, third party involvement (with a better information network) typically takes place.

The risk of nonperformance increases the expected costs associated with an export-import transaction and acts as a deterrent to trade. Therefore, trade can be facilitated if this risk can be shifted to a third-party at a known cost. More complete information typically, through foreign correspondents, in addition to risk pooling, allows the third party, who specializes in credit, to bear such risks at a lower expected cost than

Figure 1
The share of U.S. international trade financed by acceptances



NOTE: Shares are based on average acceptance maturities of 90 days.

Jack L. Hervey is a Senior Economist at the Federal Reserve Bank of Chicago. This article updates and extends "Bankers acceptances", *Business Conditions*, Federal Reserve Bank of Chicago (May 1976), pp. 3-11.

[1]The estimates are based on the average amount of export and import acceptances created and assume a 90-day average maturity. (Outstandings are from the Federal Reserve Bank of New York, "Banker's Dollar Acceptances—United States," a monthly release of the Office of Public Information, selected issues.) A shorter or longer average maturity would alter the estimates. If a 60-day average maturity were assumed, for example, the volume of export and import acceptances created in 1970 and 1982 as a proportion of total U.S. exports and imports would increase to 25 percent and 40 percent, respectively. Commercial bankers indicate that average maturity varies over time but that a 90-day average is a reasonable assumption.

an exporter who specializes in goods. Historically, the desire for such risk shifting in trade arrangements led to the development of bills of exchange such as bankers' acceptances.[2]

A bankers' acceptance

A bankers' acceptance originates from a draft drawn to finance the exchange or temporary storage of specified goods. It is a time draft that specifies the payment of a stated amount at maturity, typically less than six months in the future. The draft becomes a "bankers' acceptance" when a bank stamps and endorses it as "accepted."[3] For the price of its commission, the bank lends its name, integrity, and credit rating to the instrument and assumes primary responsibility for payment to the acceptance holder at maturity. The drawer of the draft retains a secondary liability to the acceptance holder, contingent upon the inability of the accepting bank to honor the claim at maturity.

The draft underlying an acceptance sometimes is preauthorized by a "letter of credit" issued by the importer's home bank. The largest dollar volume, however, are "outright" or "clean" acceptances—often arising from an agreement between a foreign bank (for their customer) and the accepting U.S. bank.

The drawer of the acceptance may extend credit to the importer by simply holding it until maturity and then collecting payment of the face amount from the accepting bank. Alternatively, the drawer can receive immediate payment by selling the acceptance at a discount, typically to the bank that created it.[4] The bank that discounts the acceptance may hold the instrument in its investment portfolio, treating it like any other loan financed from the bank's general funds. More commonly, the bank sells the acceptance in the secondary market, either to a specialized acceptance dealer or directly to an investor. At year-end 1982 about 88 percent of total bankers' acceptances created were "outstanding"—i.e., not held in the accounts of the accepting banks.

Acceptance market growth

Bankers' acceptances are used for two principal types of financing—for domestic trade and storage and international trade. An additional small volume of acceptances are created for the acquisition of the dollar exchange by certain countries that have periodic or seasonal shortages in their dollar foreign exchange reserves.

Although the dollar volume of trade acceptances has grown rapidly since the early 1970s, domestic acceptances have remained a small though relatively stable proportion of total acceptances over the past decade. Domestic acceptances increased from about $200 million at year-end 1969 to more than $3 billion at the end of 1982, about 4 percent of total acceptances.

Passage of the Export Trading Company Act of 1982 may facilitate a substantial expansion in the size and relative importance of bankers' acceptances for domestic shipments. This act, effective October 8, 1982, removed a longstanding statutory requirement that title documents must accompany a bankers' acceptance originated for domestic shipments in order for such an acceptance to qualify as eligible for discount by the Federal Reserve. Because this previous requirement discouraged the use of bankers' acceptances for shipments of domestic goods, 80 percent or more of the volume of domestic acceptance creation typically has been originated to finance storage rather than trade.

International trade acceptances account for the bulk of U.S. bankers' acceptance activity, typically representing more than 90 percent of the total acceptance market. International acceptances are of three basic types: acceptances to finance U.S. exports; acceptances to finance U.S. imports; and third-country acceptances to finance trade between foreign countries or goods storage within a foreign country.

The phenomenal growth of U.S. export-import acceptances has been fostered by the

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[2]Historians have traced the origin of these instruments to the twelfth century.

[3]Drafts drawn on and accepted by nonbank entities are called "trade acceptances."

[4]Typically the terms of the letter of credit specify whether the buyer or seller is responsible for payment of the commission (discount) due to the bank. If the responsibility for the discount is not specified in the agreement, convention dictates that the seller is liable for the charges.

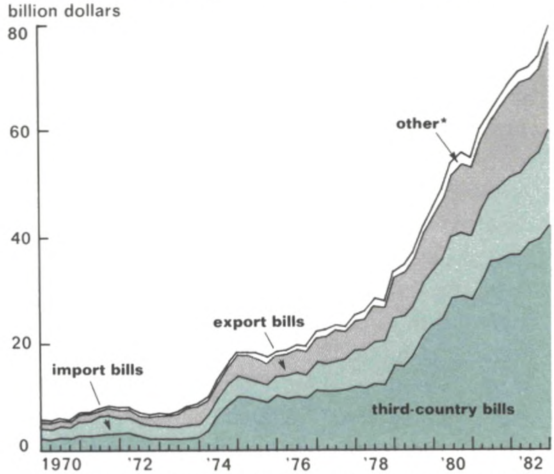
increased proportion of U.S. trade financed by acceptances, which to a large degree is due to increased attention to liability management by bankers, as well as by the expanded value of U.S. trade. Gross acceptances created to finance U.S. exports increased from $1.2 billion at year-end 1969 to $16.3 billion at the end of 1982. Over the same period, acceptances to finance imports increased from $1.9 billion to $17.7 billion.

Even more impressive has been the growth in third-country acceptances which have increased from $2.3 billion at year-end 1969 to $42.3 billion at year-end 1982. Accompanying this 18-fold increase in dollar volume, third-country acceptances have captured a larger share of the (total) international acceptance market—rising from 42 percent to 53 percent of gross acceptances created in the 1970-82 period. Expansion of the third-country market largely reflects increased usage of U.S. acceptances by Japanese, South Korean, and other Asian traders, especially in the wake of higher oil import costs for these nations after the oil price increases of 1973-74 and 1979-80.

Bankers active in the acceptance market indicate that a substantial proportion of third-country acceptances are for financing oil shipments, and growth in third-country import bills appears consistent with this claim (see Figure 2). During 1974, third-country acceptances increased from $2.7 billion to $10.1 billion. The volume increased from $16.2 billion to $35.3 billion during the period 1979 to mid-1981.

Dollar exchange acceptances, arising from exchange shortages brought about by seasonal trade patterns in some countries, are the only acceptances not based on specific merchandise trade or storage. They are available only in foreign countries designated by the Board of Governors of the Federal Reserve System. Such acceptances are relatively minor in volume, constituting only about 0.2 percent of total acceptances at year-end 1982.

Figure 2
U.S. bankers' acceptance market expanded rapidly over the past decade



*Includes acceptances to finance domestic shipments and storage and dollar exchange acceptances.

Note: Total acceptances as of the end of the quarter including acceptances held by accepting bank.

Investment in acceptances

Acceptances have characteristics that are attractive to borrowers, bankers, and investors when compared to other short-term financial instruments. This appeal has been basic to the recent rapid growth of the acceptance market.

Borrower costs for bankers' acceptances compare favorably with the interest and noninterest charges on conventional bank loans. In comparing interest rates on acceptances and other bank loans, the acceptance rate must be adjusted upward to reflect that it is quoted on a discount basis. Although typically not quoted on a discount basis, interest rates on conventional bank loans must be adjusted upward in cases where the loan contract requires a borrower to maintain compensating balances in excess of normal working balances at the lending bank. Maintaining these noninterest-earning deposits increases the effective cost of the bank loan.

Interest rates on acceptances also compare favorably with commercial paper rates. Many borrowers lack sufficient size or credit standing to issue these unsecured notes at competitive rates. For small borrowers, issuing costs or commissions add appreciably to the costs of commercial paper.

Bankers' acceptances have several characteristics that enhance their attractiveness to bankers and make them competitive with alternative money-market instruments. A bank earns a commission, currently from 50 to 100 basis points, simply by originating an acceptance. In the process, the bank does not commit its own funds unless it chooses to discount the acceptance. Once discounted, the acceptance can be sold in the well-developed secondary market, providing the bank with a degree of liquidity and portfolio flexibility not afforded by most conventional loans.

The amount of credit extended to an individual customer may also be expanded through bankers' acceptances. Statutory restrictions limit the amount of conventional credit extended to a single bank customer by a Federal Reserve member bank. However, by the creation, discount, and sale of acceptances in the secondary market, a bank can facilitate a further extension of credit to a single customer up to an additional 10 percent of the bank's capital, provided that the acceptances are eligible for discount by the Federal Reserve.[5]

Bank funds received by the sale of eligible-for-discount acceptances in the secondary market are not subject to reserve requirements under current Federal Reserve regulations. This practice has proved especially useful for channeling funds from the nonbank sector to bank credit customers during tight credit periods when Regulation Q ceilings have reduced the flow of funds to banks.[6]

[5]An outstanding acceptance of a member bank that meets the eligible for discount requirements specified in Section 13 of the Federal Reserve Act is not included in that bank's legal lending limit for conventional loans—equal to 15 percent of paid-in capital and surplus, undivided profits, subordinated debt, and 50 percent of its loan loss reserve, to any one borrower. An outstanding acceptance—which meets Section 13(7) conditions of the Federal Reserve Act—of a U.S. branch or agency of a foreign bank subject to reserve requirements under Section 7 of the International Banking Act of 1978 is also excluded from that bank's per customer limit for conventional loans. State-chartered nonmember banks and state-chartered U.S. branches and agencies of foreign banks are subject to state-imposed limitations on loans. In Illinois, for example, state-chartered nonmember U.S. banks have a legal limit for conventional loans to a single borrower of 15 percent of capital and surplus, excluding undivided profits. An Illinois-chartered nonmember bank may create acceptances for a single borrower, separate from its legal lending limit on conventional loans, in an amount up to 15 percent of capital and surplus or, if the excess is secured, up to 50 percent of capital and surplus.

[6]See Gary L. Alford, "Tight credit and the banks . . . 1966 and 1969 compared," *Business Conditions*, Federal Reserve Bank of Chicago (May 1970) pp. 4-11.

Investors hold bankers' acceptances for yield, security, and liquidity. The rates of return on acceptances have been competitive with the returns on other money-market instruments such as commercial paper and negotiable certificates of deposit. Many investors view acceptances as one of the safest forms of investment, given the primary obligation for repayment of the accepting bank and the secondary liability of the acceptance drawer. Top quality acceptances are highly liquid in the active secondary market.

Federal Reserve acceptance activities

Federal Reserve authority to regulate the creation of bankers' acceptances by depository institutions and to acquire bankers' acceptances for its own portfolio is derived from the Federal Reserve Act of 1913. Such authority has been modified by the 1915 amendments to the Act, provisions of the Monetary Control Act of 1980, and Section 207 of the Export Trading Company Act of 1982. This legislative authority provides the basis for the bankers' acceptance regulations of the Board of Governors of the Federal Reserve System—primarily Regulations A, D, and K and regulations relating to Federal Reserve open-market operations. The regulations are augmented by published Board interpretations of rules governing creation, discount, and rediscount of acceptances.

Early Federal Reserve regulations of acceptances created by its member banks focused on assurances of the quality of the instruments and the soundness of the creating banks. The Board also placed limits on the volume of acceptances available for potential discount at the Federal Reserve. Three avenues were provided for the Federal Reserve to legally acquire bankers' acceptances. The twelve Reserve Banks in the Federal Reserve System were permitted to discount (technically rediscount) member bank acceptances deemed "eligible for discount," to advance funds secured by member bank acceptances, and finally, the Federal Reserve could purchase and sell bankers' acceptances through open-market operations. Each of these transactions affected total reserves in the banking system.

Historically, most Federal Reserve transactions in acceptances arose through open-market operations.[7] Until March 1977 the Fed's Domestic Open Market Desk, located at the Federal Reserve Bank of New York, bought and sold bankers' acceptances. Fed purchases or sales from dealers in the secondary acceptance market increased or decreased reserves, respectively, in the banking system in the same manner as its dealer purchases and sales of U.S. Treasury securities. Compared to total open market operations, however, Fed purchases and sales of acceptances were small.

The Federal Reserve Open Market Committee in March 1977 directed the Open Market Desk to discontinue the outright purchase of bankers' acceptances for the Fed's own account. One reason for the discontinuance was that Federal Reserve direct purchases and sales were no longer deemed necessary to support the well-developed secondary market for acceptances. Acceptance activity for the Fed's own account now is confined to repurchase agreements.

The Fed also acts as an "agent" for foreign central banks wishing to acquire acceptances for investment purposes. Until the practice was discontinued in November 1974, the Federal Reserve also added its endorsement to such acceptances, thus enhancing the security of the instruments by effectively guaranteeing payment.

Acceptance eligibility

The Federal Reserve Act (section 13.7) specifies the general conditions under which a member bank can create an acceptance and limits the dollar volume of acceptances that may be outstanding by an individual bank. Acceptances that meet the requirements specified in Section 13(7) (see Table 1) are *eligible for discount* at the Federal Reserve, as specified in Section 13(6). Supervision and regulation of bankers' acceptances have evolved around this concept of eligibility, thereby influencing the structure of the market. Eligibility also has served as a quality benchmark in the secondary market.

Some bankers' acceptances are *eligible for purchase* by the Federal Reserve (according to rules of the Federal Open Market Committee) under marginally less stringent conditions than are those that are eligible for discount (see Table 1). It should be noted that any acceptance that is *eligible for discount,* that is, meets the conditions of 13(7) of the Federal Reserve Act, is also eligible for purchase. The reverse, however, is not true. An acceptance that meets all the conditions of 13(7) save that it has a maturity greater than six months and up to nine months is eligible for purchase but not for discount. *Eligible for purchase* is also somewhat misleading. Under current regulations this terminology actually refers to requirements that apply to repurchase agreements between acceptance dealers and the Fed, not an outright purchase for the Fed's own account. Before the Federal Reserve will enter into a repurchase agreement for an individual acceptance, the bank creating it must have established itself in the market and must have met Federal Reserve requirements that qualify the bank as a "prime bank."[8] The prime bank requirements must be met for acceptances in each eligibility category—discount or purchase—before the acceptance can be used in a Fed repurchase agreement. Bankers' acceptances that do not quality as eligible for discount or purchase by the Federal Reserve are referred to as *ineligible* acceptances. In effect, this means that all acceptances that do not meet the conditions of Section 13(7) are ineligible. Such a classification could include acceptances that are eligible for purchase but are of "long" maturities. The market treats such acceptances as ineligible.

Reserve requirements against funds obtained from the rediscount of acceptances in the sec-

[7]Federal Reserve System monetary policy was initially conducted through the rediscount of bankers' acceptances and other eligible paper. However, by the mid-1920s purchases of government securities exceeded holdings of discounted bills. In subsequent years open market operations of the System dominated rediscounting. For a discussion of the historical background of bankers' acceptances, see an article by Michael A. Goldberg, "Commercial Letters of Credit and Bankers Acceptances," pp. 175-185, in *Below the Bottom Line: The Use of Contingencies and Commitments by Commercial Banks*, Staff Studies 113 (Board of Governors of the Federal Reserve System, 1982).

[8]For a discussion of the conditions necessary for a bank to be designated a prime bank, see Ralph T. Helfrich, "Trading in Bankers' Acceptances: A View from the Acceptance Desk of the Federal Reserve Bank of New York," *Monthly Review*, Federal Reserve Bank of New York (February 1976) pp. 56-57.

Table 1: bankers' acceptances—characteristics governing eligibility, reserve requirements, and aggregate acceptance limits

	Federal Reserve System treatment			
	Eligible for discount[1]	Eligible for purchase[2]	Reserve requirements apply if sold[3]	Aggregate acceptance limits apply[4]
Bankers' acceptance categories				
1. Specific international transactions				
a. U.S. exports or imports				
Tenor - 6 months or less	yes[5]	yes	no	yes
6 months to 9 months	no	yes	yes	no
b. Shipment of goods **between** foreign countries:				
Tenor - 6 months or less	yes[5]	yes	no	yes
6 months to 9 months	no	yes	yes	no
c. Shipment of goods **within** a foreign country:				
Tenor - any term	no	no	yes	no
d. Storage of goods within a foreign country—**readily marketable** staples secured by warehouse receipt issued by an independent warehouseman:[6]				
Tenor - 6 months or less	yes[5]	no	no	yes
6 months to 9 months	no	no	yes	no
e. Dollar exchange - required by usages of trade in approved countries only:				
Tenor - 3 months or less	yes	no	no[7]	yes
more than 3 months	no	no	yes	no
2. Specific domestic transactions (i.e., within the U.S.)				
a. Domestic shipment of goods[8]:				
Tenor - 6 months or less	yes[5]	yes	no	yes
6 months to 9 months	no	yes	yes	no
b. Domestic storage - **readily marketable** staples secured by warehouse receipt issued by independent warehouseman:[6]				
Tenor - 6 months or less	yes[5]	yes	no	yes
6 months to 9 months	no	yes	yes	no
c. Domestic storage - **any** goods in the U.S. under contract of sale or going into channels of trade secured throughout their life by warehouse receipt:				
Tenor - 6 months or less	no	yes	yes	no
6 months to 9 months	no	yes	yes	no
3. Marketable time deposits (finance bills or working capital acceptances) not related to any specific transaction				
Tenor - any term	no	no	yes	no

This table is an adaptation from a table presented in an unpublished paper from the 7th Annual CIB Conference at New Orleans, October 13, 1975 by Arthur Bardenhagen, Vice President, Irving Trust Company, New York.

[1]In accordance with Regulation A of the Board of Governors as provided by the Federal Reserve Act.

[2]Authorizations for the purchase of acceptances as announced by the Federal Open Market Committee on April 1, 1974.

[3]In accordance with Regulation D of the Board of Governors as provided by the Federal Reserve Act.

[4]Member banks may accept bills in an amount not exceeding at any time 150 percent (or 200 percent if approved by the Board of Governors of (as defined the Federal Reserve System) of unimpaired capital stock in FRB, Chicago Circular No. 2156 of April 2, 1971) Acceptances growing out of domestic transactions are not to exceed 50 percent of the total of a bank's total acceptance ceiling.

[5]The tenor of nonagricultural bills may not exceed 90 days at the time they are presented for discount with the Federal Reserve.

[6]As of May 10, 1978, the Board of Governors issued the interpretation that bankers' acceptances secured by field warehouse receipts covering readily marketable staples are eligible for discount. Readily marketable staples are defined, in general, as nonbranded goods for which a ready and open market exists. There is a regularly quoted, easily accessible, objective price setting mechanism that determines the market price of the goods.

[7]Proceeds from the sale of an eligible for discount dollar exchange acceptance are not specifically exempted from reserve requirements under Regulation D, Section 204.2 a(vii) (E) effective November 13, 1980, of the Board of Governors as are other acceptances that meet the condition of Section 13(7) of the Federal Reserve act. However, the Federal Reserve Board's legal staff issued an opinion January 15, 1981, stating that the proceeds from the sale of eligible dollar exchange acceptances are exempt from reserve requirements.

[8]Prior to the amendment to Section 13(7) of the Federal Reserve act (October 8, 1982) domestic shipment acceptances required documents conveying title be attached for eligible for discount to apply.

NOTE: Tenor refers to the duration of the acceptance from its creation to maturity. An eligible for discount acceptance must be created by or endorsed by a member bank, according to Section 13(6) of the Federal Reserve Act.

ondary market are an important consideration in acceptance creation and regulation. Until 1973 member banks' funds derived from the sale of eligible as well as ineligible acceptances were free from reserve requirements. In mid-1973 the Federal Reserve Board ruled that member banks who derived funds from ineligible acceptances—those that did not meet Section 13(7) conditions—had reserve requirements on those funds.[9]

The Monetary Control Act of 1980 brought nonmember institutions under the reserve requirement authority of the Federal Reserve.[10] Regulations to implement this act also extended reserve-free treatment to funds derived from the sale of acceptances in the secondary market by these institutions. To qualify as nonreservable funds the underlying acceptances (technically eligible for purchase) were to be "of the type" specified in Section 13(7) of the Federal Reserve Act.

These rules have blurred the distinctions between acceptance eligibility for discount and for purchase. Member bank officials indicate that most acceptances created by these banks are eligible for discount. The secondary market applies a lower discount (i.e., interest rate) to acceptances that are eligible for discount and to all eligible acceptances from prime banks.

To the limited extent that nonmember depository institutions create acceptances, their instruments tend to meet the conditions of Section 13(7). Therefore, the funds obtained through rediscount in the secondary market are treated as nonreservable.

Most institutions avoid creating ineligible acceptances, because such instruments are not well received in the secondary market. In addition, reserve requirements apply when these acceptances are rediscounted in the secondary market. To the extent ineligible acceptances arise, they are usually held in the account of the bank that created them.

The secondary market

Banks place acceptances in the secondary market through two channels—direct placements and a network of dealers who "make a market" in the instruments.

The direct sale of acceptances in-house by banks' newly established money-market and investment departments has helped these banks to satisfy customer demand for short-term investments with relatively high yields. Such direct sales allow banks to avoid the added costs of selling through acceptance dealers—still the primary outlet for acceptances.

Bankers' acceptances are sold in the secondary market by a small group of money-market dealers who act as intermediaries between banks and investors. The dealer network is centered in New York City, where about 50 percent of the dollar volume of all acceptances is created. The Open Market Desk of the Federal Reserve Bank of New York is the center of Federal Reserve acceptance activity.

The dealer market has five tiers. The first tier consists of the ten largest acceptance creating domestic banks. Because acceptances of the top-tier banks are generally viewed as the safest and most marketable, these instruments command the lowest rates (i.e., discounts) in the dealer market. Second-tier banks are the next-to-largest U.S. banks in terms of acceptance creation. By virtue of their reputation among dealers and investors, second-tier acceptances usually trade at rates very close to rates for the first tier. Third- and fourth-tier institutions are those remaining U.S. banks that are somewhat active in the dealer acceptance market. Secondary market rates on lower tier acceptances vary considerably across these instruments, but are substantially higher than rates for the top two tiers.

The fifth tier of banks consists of foreign-owned institutions. A subcategory within this tier includes acceptances originated by U.S. branches of Japanese banks. These "Yankee BAs" and others in the fifth tier trade at considerably higher rates than acceptances of comparable U.S.

[9]In the early 1970s funds derived from the sale of ineligible acceptances were not subject to reserve requirements. A number of banks used this fact to advantage during periods of tight credit by creating a substantial volume of finance bills, or working capital acceptances (ineligible), and placing them in the secondary market. The Board of Governors imposed reserve requirements in mid-1973 on bank funds acquired through such instruments, sharply curtailing banks' activity in ineligibles.

[10]Prior to the Monetary Control Act of 1980, reserve requirements on nonmember bank funds acquired from the sale of ineligible bankers' acceptances in the secondary market were set by state banking laws.

banks. The main reason appears to be the lack of investor recognition of the names and credit standings of these foreign banks—even those among the largest banks in the world. Presumably, rate differentials between fifth-tier acceptances and those in the upper tiers will be lower in the future if information and efficiency in the secondary market improves.[11]

Acceptances in the top two tiers are eligible for discount, having been created by member banks.[12] Indeed, dealers are disinclined to trade acceptances that are ineligible for discount or that meet only minimum requirements of eligibility for Fed purchase. All dealers exclude ineligible acceptances from the conventional tier structure, and some dealers refuse to trade ineligible acceptances.

Current regulatory issues

Prior to the amendment of Section 13(7) of the Federal Reserve Act in October 1982, total outstanding acceptances of an individual bank—acceptances created but not held by the bank—were limited to an amount equal to or less than ". . . one-half of its paid-up and unimpaired capital stock and surplus." Subject to approval from the Federal Reserve Board, the limit on outstanding acceptances could be raised to an amount up to 100 percent of paid-in capital and surplus.

These ceilings posed problems for many major acceptance banks in the late 1970s, even though all major acceptance creating banks had been allowed to expand their individual limits ("aggregate ceilings") on the total volume of acceptances outstanding to 100 percent of capital stock plus surplus.[13] Rapid growth in acceptance volume outpaced the modest growth in banks' capital and threatened to slow the growth of the acceptance market or divert much of the growth to smaller regional banks and U.S. branches of foreign banks.

Legislation relaxing the ceiling on outstanding acceptances, introduced in the Congress in 1981, finally was enacted in October 1982 as part of the Export Trading Company Act of 1982. Section 207 of this act amended Section 13(7) of the Federal Reserve Act in five significant areas, including increases in the aggregate ceilings on acceptances (see box on recent legislation). For the most part, this legislation avoided a number of fundamental issues and simply focused on relaxing the permissible ceiling for acceptances as an expedient for market expansion. Further flexibility for individual institutions was provided by permission for "covered" institutions to "participate out" acceptances with other "covered" institutions (member banks and U.S. branches of foreign banks). Through such participations, they are, in effect, permitted to pool the amount of acceptances as a percentage of their joint capital. The acceptance creating bank is allowed to remove the participated acceptance from the amount that counts against its total aggregate ceiling and the amount is added to the total that counts against the other bank's aggregate ceiling.

The debate over this legislation has prompted renewed interest in a broad range of issues, including concentration in the primary and secondary acceptance markets, application of reserve requirements to acceptances, regulatory and institutional features of the secondary market, and the more basic issue of the uniqueness of acceptances for regulatory purposes.

The provisions of the Export Trading Com-

[11]For additional details on the operation of the secondary market, see William C. Melton and Jean M. Mahr, "Bankers Acceptances" *Quarterly Review* of the Federal Reserve Bank of New York, Vol. 6, No. 2 (Summer 1981) pp. 39-55.

[12]Recall that a member bank acceptance that meets the requirements of Section 13(7) is eligible for discount. For a nonmember bank, an acceptance meeting the same conditions is eligible for purchase (see Table 1). A member or nonmember bank may create an acceptance that is eligible for purchase but that does not meet the requirements of Section 13(7), because its original maturity is in excess of 180 days. Proceeds from the sale of such an ineligible acceptance in the secondary market would be subject to reserve requirements.

[13]Ceilings on the total amount of eligible acceptances outstanding by an individual bank may have resulted in an anomaly in the market. Suppose a member bank creates an acceptance that is eligible for discount in all respects, except the bank now exceeds its Section 13(7) aggregate ceiling. Because such an acceptance does not meet all Section 13(7) requirements, it becomes ineligible for regulatory purposes and subject to reserve requirements. However, the secondary market will treat that acceptance as eligible. It should be noted that this informal interpretation is widely, but not uniformly, accepted and, consequently, needs clarification

Recent acceptance legislation

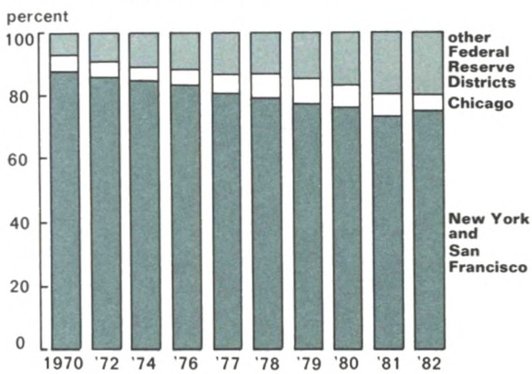
Section 13(7) of the Federal Reserve Act (12 U.S.C. 372), the principal statute governing acceptance creation, was amended in Section 207 of the Export Trading Company Act of 1982. Section 207 contains five modifications in the regulations governing acceptances, four of which deal with ceilings on outstanding acceptances of individual financial institutions.

- The volume of outstanding acceptances—those sold in the secondary market—was raised from 50 percent to 150 percent of an individual financial institution's "paid-up and unimpaired capital stocks and surplus." This 150 percent rule applies to the maximum amount of outstanding acceptances that an individual institution can have and still qualify its acceptances as eligible for discount under Section 13(6) or purchase under Federal Open Market Committee regulations. Subject to Board approval, the 150 percent rule is relaxed. The upper limit on outstanding acceptances then becomes 200 percent of a financial institution's paid-up capital and surplus. The previous limit subject to Board approval was 100 percent.
- Member banks and U.S. branches and agencies of foreign banks ("covered institutions") now are permitted to participate an acceptance with other such institutions, provided that the participation meets Federal Reserve regulation. By "participating out" a portion of its acceptances to another institution, the creator of the acceptances does not need to count the participated portion in calculating its level of outstanding acceptances—it does not count against its aggregate ceiling—provided that the participating institution is a Federal Reserve member or a qualified U.S. branch or agency of a foreign bank.
- Any federal or state branch or agency of a foreign bank subject to reserve requirements under Section 7 of the International Banking Act of 1980 now becomes subject to the provisions of Section 13(7) of the Federal Reserve Act. In particular, these institutions become subject to aggregate ceilings on outstanding acceptances, stated in terms of the outstanding acceptances of all U.S. branches and agencies of a given foreign bank as a percentage of the total capital and surplus of the parent institution. No federally imposed aggregate ceilings on outstanding acceptances previously applied to foreign institutions.
- Total acceptances arising from domestic transactions (shipping and storage) may not exceed 50 percent of an individual institution's allowable outstanding acceptances, including participations. The previous ceiling for domestic acceptances was 50 percent of an institution's paid-in capital and surplus.
- Shipping documents conveying or securing title no longer must be attached at the time of origination for eligible acceptances that finance domestic shipments. This change eliminates a crucial difference in the definition of eligible acceptances between foreign and domestic acceptances in the shipments category.

pany Act could slow, or even reverse, the restructuring of the supply side of the market in recent years, evidenced by increased acceptance origination at regional banks and U.S. branches of foreign banks (see Figures 3 and 4). A reconcentration of the market, prompted by the increase in acceptance ceilings for large banks, actually might be favored by the secondary market. Such concentration deepens the market for the most liquid acceptances in the top tiers at the expense of growth and deepening of the market for acceptances in the lower tiers.

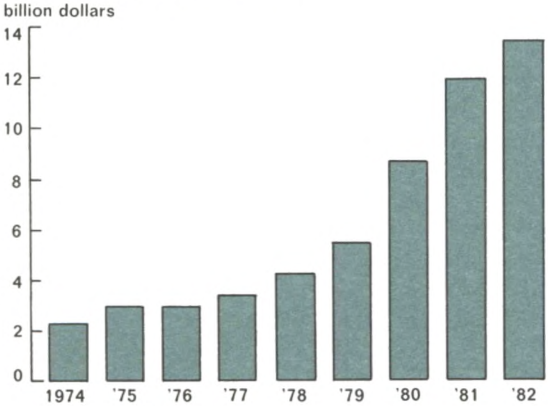
Banking, trade, transportation, and communications have changed drastically over the more than 50 years of acceptance legislation. It

Figure 3
Regional banks increase their share of the acceptance market



NOTE: Based on year-end data.

Figure 4
Acceptances outstanding from U.S. branches and agencies of foreign banks triple since 1978



NOTE: Based on year-end data.

can be argued that the regulation of bankers' acceptances has failed to keep pace. Implementation of the Monetary Control Act of 1980 left little practical application for the concept of eligibility for discount as applied to member bank acceptances. The principal application of this concept, as specified in the amended Section 13(7) of the Federal Reserve Act, arises in outlining the administrative rules for acceptances of nonmember depository institutions.

The maturity, or tenor, of created acceptances has been a point of confusion in the market. According to amended Section 13(7) and subsequent legislation, member banks may create acceptances eligible for discount with maturities up to 180 days. Under current Open Market Committee regulations, depository institutions in general may create acceptances eligible for purchase with maturities up to 180 days. Neither category with a 180-day maturity is subject to reserve requirements when sold in the secondary market. However, Open Market Committee regulations also permit the creation of acceptances eligible for purchase with maturities up to 270 days. Such acceptances with maturities over 180 days are subject to reserve requirements when sold in the secondary market. Confusion sometimes arises because of the regulatory anomaly that acceptances eligible for purchase with original maturities between 180 and 270 days are subject to reserve requirements when sold in the secondary market, even if the remaining maturity at the time of such sale does not exceed 180 days.

Two regulatory and institutional aspects of the secondary acceptance market deserve careful reexamination. One such feature is the extensive paper shuffling that results from acceptances being physically transported from banks to dealers to investors. Existing technology for book-entry and electronic transactions could be applied to make secondary market transactions substantially more efficient, especially for investors not located near dealers. A second feature needing reexamination is the tier structure of the market, which probably understates the quality of acceptances in the lower tiers, particularly the dollar acceptances of foreign banks.

Back to basics

Bankers, regulators, and economists disagree over basic issues of the uniqueness of bankers' acceptances and the appropriateness of special regulations covering these instruments. The argument for uniqueness derives from the linkage between the provision of credit and a specific trade transaction matched in maturity and amount. This linkage is considered the basic distinguishing feature of an acceptance. The opposing view, however, emphasizes that it is becoming increasingly difficult to identify many acceptances on the basis of such a linkage to trade. The importance of the linkage of an acceptance to specific imported goods derives from the traditional "self-liquidating" nature of the credit provided by an acceptance. That is, the credit obligation of the acceptance can be liquidated through the sale of the imported goods to which the acceptance is specifically tied. It can be argued, however, that the self-liquidating nature of acceptances does not provide a convincing rationale for the special regulatory status of acceptances.

To understand the funding properties of an acceptance, it is useful to compare a bank's acceptance activity to its funding of a conventional loan through the sale of a certificate of deposit (CD). Three principal differences exist for the two types of bank funding operations. The first is that under current regulations the funds obtained through the sale of an eligible bankers' acceptance in the secondary market are not subject to reserve requirements. Therefore, acceptances provide a potentially cheaper source of funds than CDs on which reserve requirements are applied.

Second, theoretically an acceptance is tied to a specific transaction for a stated time period. While it is true that the importer may extinguish its liability at any time by prepaying it to the accepting bank, there is little incentive to do so because the effective cost of the credit extended would increase. In the case of CD funding of trade credit, the maturity of the loan and the maturity of the CD funding instrument in most cases would not coincide. The loan may be secured by the trade shipment, but the loan and the traded goods are not directly related to the CD. Bank funds raised through CD issuance are fungible—i.e., these funds can be used for any permissible bank investment purpose. On the other hand, an acceptance theoretically is tied to a specific transaction. The acceptance may not be "rolled over," (unless under exceptional circumstances such as the goods being tied up at dockside due to a dock strike, for example) nor may a new acceptance be created to cover the same transaction. If an extension of credit were needed to finance the transaction for a longer period than permitted under the terms of the original acceptance an alternative credit arrangement would be required. If the lending bank were to extend the customer's credit, the funding of that loan would have to incorporate some alternative liability management arrangement. Therefore, trade financing through acceptances and through loans financed by CDs have differing implications for asset-liability management.

The third difference between these funding techniques deals with the types of investor security provided by the instruments. For a bankers' acceptance acquired in the secondary market, the investor is protected by the primary liability of the acceptance bank and the secondary, or contingent, liability of the drawer of the acceptance. The CD holder has only the primary liability of the issuing bank (plus deposit insurance protection up to $100,000).

To date, the distinctions between bankers' acceptances and other funding methods have been viewed by legislators and regulators as sufficient reasons for treating acceptances as special instruments. As a result, bankers' acceptances continue to be distinct financial instruments that are growing in importance and gaining increased market approval. This view could change in the future, however, for as the size of the market increases, the issues of uniqueness and preferential regulation are likely to receive a more critical appraisal.

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U.S. Board of Governors of the Federal Reserve System. Federal Reserve Act (approved December 23, 1913) as amended. (Also, 12 USCA various sections).

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