BANK HOLDING COMPANIES: WHERE WE STAND

Remarks of Mr. Robert P. Mayo
President of the Federal Reserve Bank
of Chicago
Chicago Chapter of the Bank Administration Institute
Chicago, Illinois
November 16, 1971

Tonight I want to talk about bank holding companies. This is an area that has generated far less publicity than subjects like the President's new economic program but it is an area of significant importance and vital concern to the Fed and to the banking system you represent. It has short-run significance to many of you right now. It has long-run significance to all of us as it establishes some new guidelines for the future of the whole industry of banking. It is also an area where the Chicago Federal Reserve Bank has some direct responsibilities.

Now, I know that for many groups this could be a pretty deadly topic. But obviously, I don't think there is much risk with you. Many of you are directly involved in planning your bank's future course of action. I'm going to take another risk too by not striving for an inspirational speech. I don't think you came here for inspiration but for some background and ideas on the thrust of policy in the bank holding company area.

With only slight exaggeration, the Bank Holding Company Act Amendments of 1970 have been called the "most important banking legislation since the Federal Reserve Act." The Amendments gave concrete expression to Congressional concern about the nature of our banking system and the general shape of the American economy not only today and for the next few years, but well down the road into the foreseeable future.

How did such a momentous piece of legislation come into being? What does it say and, more to the point, what does it mean? What does it portend for bankers and the American economy in the 1970s? Undoubtedly, each of you here has pondered these questions at some length during the past several months. But it may be worthwhile to review the events of the past several years, putting them in perspective and using them to illuminate subsequent developments.

Rise of the One-Bank Holding Company

Prior to 1967, if you had asked the typical banker what a one-bank holding company was he may have given you a blank stare. The existence of such an animal was simply unknown to most people, and even within the small group of bankers, businessmen, and regulators who did know about it, the one-bank holding company was just beginning to become a matter of interest or concern.

As far back as the early 1950s, representatives of the Federal Reserve had argued before Congressional committees that the abuses at which regulation of bank holding companies was directed were not dependent on the number of banks owned by the holding company. Nevertheless, the Bank Holding Company Act of 1956 and its 1966 revision both limited Federal Reserve regulation to companies owning or controlling 25 percent or more of the stock of two or more banks. This reflected Congressional preoccupation with the expansion within and across state lines of a number of large multi-bank holding companies, threatening to bring about a great increase in the concentration of banking resources.

As late as the early 1960s, nothing had occurred to make closing the one-bank loophole an urgent matter of public concern. Although one-bank holding companies grew rapidly in number between 1955 and 1965--from 117 to 550--most of them were small and the fact that they combined banking with nonbanking activities under one corporate roof often reflected nothing more than the availability of investment opportunities.

Beginning in 1968, however, the one-bank holding company movement--by this time it was accurate to describe it as such--took a new turn that was sufficiently dramatic to catch the eyes of many who up until then had ignored it. The turning point may be dated by the formation by the First National City Bank of New York of a holding company to own its own shares. More significantly, First National City Corporation, as the holding company was named, announced its intention to diversify into a wide variety of activities heretofore prohibited to banks as such.

In large measure, this move reflected an attempt to circumvent legal obstacles encountered when First National City Bank had attempted to enter new activities directly. Other banks had been encountering similar barriers to their diversification efforts.

Long before the judicial system had provided even tentative answers to the questions, other major banks followed the path and began to enter nonbanking fields indirectly via the acquisition or establishment of holding company subsidiaries. By December 31, 1968, seven of the ten largest banks in the United States--and 30 of the 40 largest national banks--had formed one-bank holding companies. Although some bankers continued to watch and wait on the sidelines, it was clear that many believed they had found the key which would unlock what, in their view, were unduly harsh restrictions on the activities of commercial banks. The movement gathered new momentum. By April 1, 1970, one-bank holding companies controlled 1,116 banks and one-third of the deposits of all commercial banks in the country.

Reaction and Response

It was too much to expect that such a revolutionary transformation of the organization of banking and of the relationship between banking and other sectors of the economy would go unchallenged --by firms in the industries being invaded by subsidiaries of the holding companies, by bankers and businessmen to whom memories of the holding company abuses of the 1920s were still vivid, and by academicians and regulators concerned about the potential implications of unbridled holding company expansion for the safety, efficiency, and competitiveness of the financial system. At the extreme, one was confronted with wildly exaggerated prophecies of the replacement of arms-length bargaining between borrower and lender with the sort of community of financial and industrial interests represented by the Japanese Zaibatsu. The death of the free enterprise system was solemnly predicted, as were the demise of our democratic institutions and their replacement by a quasi-fascist form of state capitalism.

One need not endorse the more far-fetched of these flights of fancy to acknowledge the grain of truth that they all contained. Indeed, I wish to make plain my strong disagreement with those who believe that the one-bank holding company movement should have been allowed to run its course unchallenged, undebated, and restrained only by the forces of the marketplace. Just as a free society requires the maintenance of some semblance of order, the preservation of a free competitive process presupposes some broad restraints on the behavior of market participants. This is an inescapable and well-known paradox, perhaps most familiar to us in the arguments for constitutional government or, more narrowly, in the generally acknowledged need for antitrust legislation. In the case of bank holding companies, it may well be that the maintenance of a competitive financial system that dispenses credit efficiently and without favoritism presupposes the separation of lender and borrower--in effect, that it limits the diversification of banks into other activities.

The bills proposed covered the entire spectrum of attitudes toward the industry. Representative Wright Patman's bill, which was strongly supported by representatives of the insurance, travel agency, data processing, and mortgage and investment banking industries, would have spelled out once and for all a narrow "laundry list" of permissible activities for bank holding companies. With few exceptions, these would all be activities that banks had traditionally engaged in, or that were extremely limited extensions of their basic loan and deposit function.

The Administration bill favored by the American Bankers Association--once that body had reconciled itself to the necessity of having any new legislation at all--did not mention any specific activities that would be permitted or prohibited to banks. Instead, it spelled out certain broad criteria for determining what would be permissible and assigned responsibility for making this determination to the

Comptroller of the Currency, the Federal Reserve, or the Federal Deposit Insurance Corporation. It was widely believed that this division of enforcement responsibility would favor a liberal interpretation of what was permissible.

It is a measure of the genius of the American political system that the legislation finally adopted bore little resemblance to--indeed, was superior to--any one of the extreme measures proposed by the contesting parties. Moreover, it was much more than a crude compromise of opposing interests and, with the possible exception of the grandfather clause, reflected next to nothing of the ignoble sentiments that had pervaded the entire debate.

With a few reservations, I believe the legislation was sound and in the best long-run interests of the banking system, the economy, and the nation. Although only time will tell, I believe that its basic principles and provisions will have a profound effect on the evolution of the American financial system over at least the next two or three decades.

The New Amendments

The 1970 Amendments to the Bank Holding Company Act contain many important exceptions, qualifications, and other details, but their essence is rather simply stated. First, they extend the coverage of the Act to all bank holding companies, eliminating the one-bank loophole; the amended Act makes no distinction in its treatment of one-bank and multi-bank holding companies. Second, all companies that became bank holding companies by virtue of the Amendments must register with the Federal Reserve, thereby providing some essential data not hitherto available on their number, size, and activities.

This step should be completed within the next month or so. Third, and most important of all, Section 4(c)(8) of the amended Act lays down the criteria for determining the permissibility of individual nonbanking activities of bank holding companies. The actual determinations, as under the old Act, are left to the Board of Governors of the Federal Reserve System.

The first test that such activities must meet is "to be so closely related to banking or managing or controlling banks as to be a proper incident thereto." This is almost identical to the wording of the old Section 4(c)(8), reflecting the refusal of Congress to adopt any of the proposed alternatives such as "functionally related to banking." Congress did liberalize the Section somewhat by eliminating the stipulation that the activities of bank holding companies and their subsidiaries "be of a financial, fiduciary, or insurance nature. . .."

But Congress also added an entirely new standard to the Act, which reads as follows:

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

The Board has interpreted Section 4(c)(8) as embodying two distinct tests, both of which must be passed if a given activity is to be approved. Permissible activities must be both closely related to banking and in the public interest when performed by a bank holding company affiliate. Moreover, even though the activity is considered permissible, each specific proposal to engage in it, whether de novo or by acquisition of a going concern, must pass the public interest test.

The words "closely related to banking" are so vague as to create some extremely difficult problems of interpretation. One basic problem is that the nature of banking itself is constantly changing rather than static. Over the past half century, banking has undergone a fundamental transformation from a wholesale-oriented business concentrating on short-term lending to business to a department store of financial services with an increasingly retail-oriented approach. Some of these new functions have been disallowed by the courts; but those that may remain constitute major changes in what it is that constitutes "banking." Hence, what is "closely related to banking" may be subject to evolution over time.

As for the public interest standard, the Federal Reserve finds itself having to blaze new paths of interpretation and analysis. It is required, in effect, to measure all the costs and benefits of allowing holding company affiliates to perform a given activity, to weigh them in some unspecified manner, and to decide on the basis of the result whether the activity should be permitted.

Consequently, implementation of the Amendments dealing with non-banking activities is proceeding slowly and cautiously.

Implementing the Amendments

Although the Board of Governors in Washington is empowered to approve activities either by the promulgation of general regulations or by order in individual cases, it indicated its intention to proceed by regulation and to process individual applications under the new Section 4(c)(8) only "in unusual and exigent circumstances." The purpose of this deferral of applications was obviously to give the Board time to consider some of the broader issues before getting bogged down in a heavy caseload of applications for the acquisition of companies engaged in activities that may not even by among those eventually declared to be permissible.

In March of this year, the Board announced its intention to hold its first hearings on ten activities that it was considering. As expected, the hearings generated a great deal of heat and at least some light. It is perhaps not too unkind to remark that much of the testimony received was little more than a rehash of arguments already familiar to the Board through the transcripts of the hearings held by the Senate and House Banking Committees.

In any case, the Board has proceeded to move ahead in the development of a list of permissible activities. On May 27, it approved seven activities, including:

1. Making or acquiring, loans and other extensions of credit.
2. Operating as an industrial bank, Morris Plan bank, or industrial loan company.
3. Servicing loans and other extensions of credit.
4. Performing or carrying on functions that may be performed or carried on by a trust company.
5. Acting as investment or financial adviser to a mortgage or real estate investment trust.
6. Leasing personal property and equipment, or acting as agent, broker, or adviser in leasing of such property.
7. Making equity and debt investments in corporations or projects designed primarily to promote community welfare.

In doing so, the Board indicated that it was not imposing any general limitation on the location of nonbanking activities, but might impose such limitations by order in individual cases. It also made clear that the activities of approved holding company subsidiaries were not to "be altered in any significant respect from those considered by the Board."

An eighth activity--data processing services--was added to the approved list on June 15. In approving it, the Board imposed fewer restrictions than expected--fewer even then in its original proposal--and thereby produced a great deal of teeth-gnashing in the data processing industry.

In general, the Board has not seen its role as rubberstamping decisions made by other agencies regarding appropriate activities for banks. Thus, the fact that the Comptroller of the Currency had ruled that a national bank might offer a given service would not be taken as conclusive in determining whether the same service would be permissible for bank holding companies. This could lead to a situation in which a Board refusal to authorize an activity for bank holding companies could be nullified by the bank's carrying on the activity directly. A possible deviation from this general policy was the Board's action, effective September 1, adding insurance agency and broker functions to the list of permissible activities. That such activity had been performed by state banks for many years where permitted by state law and by national banks in communities with populations not exceeding 5,000 probably was not totally ignored by the Board in its decision.

Since then the Board has issued proposals that "serving as investment advisers to mutual funds" and "performing property management services" be added to the list of permissible activities. The legality of bank holding companies acting as advisers to mutual funds was questioned as a possible violation of the Glass-Steagall Act separating commercial and investment banking. The Board held hearings on the activity on November 12 and will probably reach some decision on the matter in the near future.

A Board press release on May 27 announced that applications to engage in nonbanking activities subject to Section 4(c)(8) were being accepted. Since then the number of such applications has gradually risen, as the principles governing the Board's actions on such applications have become clearer. As expected, applications for de novo entry by bank holding companies into activities already included on the approved list have received liberal treatment. Indeed, most such applications are deemed automatically approved unless objections are raised by the regional Reserve bank. The Board has not as yet, however, acted on acquisitions.

In the area of acquisitions, mortgage companies have produced the greatest activity and raised some of the most difficult problems, especially with regard to competitive effects. As of late October, the Board had under consideration seven applications to acquire mortgage companies, many involving extremely large banks and leading mortgage companies in the same city. Because both banks and mortgage companies make real estate loans, there is considerable competitive overlap between the activities of the two types of institutions. Consequently, there is some question whether bank holding companies should be allowed to acquire mortgage companies located within the same local geographic area served by the holding company's bank or banks. On October 26, the Board scheduled hearings on the issues in such cases, and these were held on November 8. At the same time it scheduled hearings for November 12 on factoring and serving as investment advisers to mutual funds.

The hearings on mortgage companies and the actions taken by the Board on the first several applications involving mortgage companies warrant your closest consideration. In addition to setting precedents for subsequent cases, the actions taken by the Board in these cases will serve as a useful indicator of its attitudes toward the competitive and other issues in holding company expansion into nonbanking areas generally.

To paraphrase, an old saw usually applied to the Supreme Court's interpretation of the Constitution, but not too far off the mark in the present context--the Bank Holding Company Act Amendments of 1970 mean what the Board says they mean.

Many other questions related to the implementation of Amendments have been dealt within recent months. For example, on September 20, the Board announced the types of foreign business activities that would be permissible for domestic bank holding companies. On the same day, the Board issued a list of rules and presumptions that would guide it in determining when a company exercises control over a bank or other company. These rules were designed to simplify implementation of the section of the 1970 Amendments which broadens the Board's ability to find control in some situations when a company owns less than 25 percent of a bank's stock. Many other minor issues have been dealt with along the way since the Amendments were enacted at the end of last year.

But the fact remains that the key issue in the implementation of the Amendments is the treatment to be accorded holding company plans for expansion into nonbanking areas. Although Congress originally set out to settle just this question--and succeeded, in the sense of specifying the broad criteria that should govern such expansion--the buck has now passed to the Board of Governors. It is, of course, too early to speculate about the details of the Board's ultimate policy. But several principles have already become clear. The Board is on record as being sympathetic to the banks' reasons for wanting to expand their horizons. There is no obvious reason why arbitrary restrictions should limit commercial bank participation--whether directly or via the holding company route--in the great expansion of the financial service industry expected over the next several decades. At the same time, the Board has every intention of supporting the clear mandate of Congress that the separation between banking and commerce be preserved. It is willing to see the wall between the two displaced only to the extent that the holding company form of organization offers some insulation from the possible adverse effects that might accompany the banks' entry into certain activities directly.

Regarding acquisitions of companies in lines of business already included on the approved list, final conclusions must await the Board's action in the first cases. My own belief is that the Board will apply essentially the same strict competitive standards that have marked its decisions on applications to acquire banks, modified only to the extent necessary to take into account the additional criteria included in the new public interest test. Beyond that, I can only suggest that the next year or so should be every bit as interesting as the last two in the area of bank holding company expansion.