Remarks of Mr. Robert P. Mayo
President, Federal Reserve Bank of Chicago
to The 41st Assembly for Bank Directors
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Utilizing the Bank Holding Company

I am pleased to have been asked to participate in this session on bank holding companies. As an organizational form, the bank holding company has become increasingly important and I think that a better understanding of its benefits both to you and to the public generally is essential.

Jim Hall will be focusing (has focused) on the bank holding company from the standpoint of the "private" advantages. My remarks will be directed primarily to the "public" considerations; that is, bank holding company regulation as seen from the Federal Reserve's perspective.

The use of the bank holding company as an organizational form for owning and controlling commercial banks is neither a new device nor a recent one. In fact, it dates back to around 1900. At that time, the bank holding company provided a device for owning several banks at a time when branching was prohibited, or severely limited, in every state. To this very day, restrictive branching laws have remained one of the primary reasons for embracing the holding company organizational form as banks have sought to approach the geographic mobility of their customers. Multibank holding companies tend to be most important in those states with highly restrictive branching laws and to be relatively unimportant in those states that allow statewide branching. In states that prohibit multibank holding companies, chain or group banking has flourished. What distinguishes bank holding companies from chain banking organizations, of course, is the fact that bank holding companies are formally organized and are generally chartered as corporations.

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Bank holding companies have been organized to get around not only state branching restrictions but other types of banking regulation as well. One of the more common reasons for forming bank holding companies was to engage in activities that banks were prohibited from performing themselves, or engaging in a permissible activity (like lending) but at a geographic location where a particular bank subsidiary was not allowed to operate.

Holding company flexibility takes other forms as well. The parent bank holding company, like any other kind of holding company, is able to exploit a very useful accounting device--the holding company parent is able to raise debt by borrowing, from a bank or the capital market, and can downstream these borrowed funds to its bank subsidiary so that it appears as common stock or equity on the bank's balance sheet. This seemingly magical transformation from debt to equity has been accorded the loaded label of "double leveraging." While not unique to banking, it is another example of the flexibility of the holding company mechanism as a device for circumventing certain regulatory barriers.

It was Congress's concern with a few abuses of the flexibility of the bank holding company device that led to the first regulation of bank holding companies in 1933. This early holding company regulation, incorporated in the Banking Act of 1933, gave the Board of Governors of the Federal Reserve System the power to disallow corporations the right to vote the shares of a member bank which it controlled. To be given the Board's permission to vote its shares, the holding company had to avoid unsound banking practices and allow the Board's examiners to examine the affiliated banks of the holding company.

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The bank holding company form of organization declined in importance during the 1930s and early 1940s, thus minimizing the need for additional regulation, particularly with regard to the formation and expansion of holding companies. But a major merger movement began following World War II. Existing bank holding companies began to increase the number of banks they controlled. A few of these holding companies operated banks in several states. In addition, some bank holding companies were being used as a corporate device to engage in business activities unrelated to banking, thus evading the intent of the Banking Act of 1933 which, among other things, sought to separate banking from other lines of commerce.

Comprehensive Federal regulation of bank holding companies was not enacted until 1956. The main thrust of the Bank Holding Company Act of 1956 was that it formally recognized the bank holding company, despite some abuses that had taken place in the past, as a legitimate form of banking organization, the formation and expansion of which may be in the public interest _if properly regulated and controlled_.

Congress had three primary concerns with bank holding companies that it felt could be dealt with most effectively by regulation. First, there was the fear of economic concentration, and the social and political overtones associated with it. The increased number of banks affiliated with bank holding companies, while certainly not posing a monopoly problem--there were still more than 13,000 insured commercial banks in operation in 1956--did, nevertheless, give rise to concern with increased concentration of financial resources, particularly at the state and local level. Congress tried to nip this trend in the bud by applying the antitrust laws to bank holding company expansion.

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A second concern of Congress was the potential for unsound banking practices facilitated by the holding company form of organization. Because of this concern, Congress directed the Federal Reserve Board to consider financial and managerial criteria in determining whether to approve or deny an application by a multibank holding company to acquire an additional bank. Congress's last major concern, addressed in the Bank Holding Company Act, was that a holding company's nonbanking activities should be strictly circumscribed, being merely "a proper incident to" banking and limited to activities of a "financial, fiduciary, or insurance nature."

Companies that controlled only one bank were not covered by the 1956 legislation. In part this was because there weren't very many of them; their control was primarily limited to small banks; and there were few, if any, abuses or circumventions of regulation by these companies. Following the credit squeeze of 1966, many bankers began to realize that a holding company might provide improved access to the money and capital markets, but in particular, to the commercial paper market where there were no interest rate ceilings to contend with. As a result, many of the nation's largest banks began to organize holding companies so that they would be better prepared to have the financial flexibility they wanted to deal with the next credit squeeze. Many of these one-bank holding companies also took advantage of their unregulated status by performing nonbanking activities that were prohibited to their bank subsidiary, or performing bank-like activities at locations where their bank was not allowed to operate. Congressional concern with the performance of these nonbank activities, particularly those that clearly broke with this nation's tradition of a bank's dealing at arm's length

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with its customers, resulted in closing the one-bank loophole in 1970.

Current Federal Reserve Emphasis

The remainder of my comments might well be titled, "So you want to be a bank holding company--what should you expect?" There are many benefits to being part of a bank holding company, but, I might add, that most of these benefits are the private benefits that accrue to the owners of the holding company. To some extent, of course, these benefits may trickle down to a holding company's customers and translate into benefits to the general public. The focus of the Bank Holding Company Act is on net benefits to the public that outweigh any possible adverse effects such as unsound banking practices, conflicts of interest, undue concentration of resources, and anticompetitive effects. Thus the Federal Reserve is charged by law with examining the impact of holding companies on bank customers.

The benefits of a bank holding company to stockholders are numerous. Among these benefits are tax deferral and tax avoidance, financial leverage, improved access to capital markets and the ability to expand one's product and geographic markets. The last two of these private advantages translate into improved convenience and needs to the public--one of the factors that the Federal Reserve must take into consideration in weighing all applications.

The Fed is also charged with two other factors that must be considered in deciding on the merits of an application. First, we must focus on the competitive effects that will result from a holding company formation or the acquisition of a bank. If we find anticompetitive effects, then we can give weight to enhanced convenience and needs or improved managerial or financial factors. I should mention in passing, however, that serious anticompetitive effects have, in practice, never been outweighed by these

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other considerations except where the acquired bank was on the brink of failure. Where the anticompetitive effects are only slight, these effects can be, and in practice have been, outweighed by enhanced convenience and needs or financial factors--for example, by the provision of new or additional services, a commitment to increase interest rates to Regulation Q ceilings, or an injection of equity capital into one of the holding company's banks.

Regardless of whether there are anticompetitive effects, the Board must examine, in every application, convenience and needs and financial factors. As a result, the Board has, by denying dozens of applications, voiced its concern about the use of the holding company device as a means of increasing financial leverage and achieving tax avoidance at the expense of the potential safety and soundness of the subsidiary bank. I might add that the Board's legal authority to concern itself with the capitalization of affiliated banks over which it has no direct supervisory authority was upheld by the U.S. Supreme Court in the 1979 First Lincolnwood decision.

So if you are planning to form or expand a bank holding company, one thought to keep in mind is the requirement that the application, which is part of the public record, makes a compelling case that the public will benefit as a result of your proposal. It is, of course, a foregone conclusion that the holding company, and its owners, will benefit--or else why would the transaction be undertaken in the first place? It is the responsibility of the Federal Reserve to ensure that a holding company does not benefit at the expense of the nonbank public. In order to carry out this responsibility and to satisfy the legal requirement of a complete public record, the Fed requires that a standard application for prior approval be

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submitted--in multiple form, since copies must go to the Board, the Reserve Bank, other appropriate bank regulators, and the Justice Department.

Each application has several sections that deal with a description of the transaction and its competitive, financial, and convenience and needs implications. More recently, several questions have been added that deal with compliance with the spirit and intent of the Community Reinvestment Act. Rarely is an application submitted that contains fewer than 50 pages; the majority of applicants submit at least 75 pages; and it is not unusual for applications involving complex transactions to total more than 200 pages. To a considerable extent, this one-time reporting burden is mandated by the requirement that an application be "legally sufficient and informationally adequate." This could be more euphemistically expressed as the need for an application to contain all information necessary for a reasonable man to make a judgment as to whether it should be approved or denied. The time involved in processing an application has generally been reduced when the applicant has assumed a large burden of the proof by making certain that the application supports, with fact, the public benefits contended.

Now I, and others, in the Federal Reserve System have been very much concerned with both on-going and one-time reporting burdens by banks and bank holding companies. Filing a bank holding company application is not inexpensive. Harvey Rosenblum, one of the economists in our Chicago Fed Research Department, has done considerable research in this area. He finds that, on average, it would cost the applicant approximately $15,000 to put together an application to form a one-bank holding company and almost that much for an existing holding company to apply to acquire another bank. In addition, holding companies must file an annual report

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with the Fed; this typically costs at least $1,000 and for the larger, active, or complex holding companies, around $3,000-$5,000. Those companies with assets exceeding $300 million have additional reporting requirements, as well as more frequent--generally annual--inspection by a Federal Reserve team to assure compliance with the bank holding company laws and to assess the overall financial condition of the company. Those bank holding companies with more than 500 stockholders must also file reports with the Securities and Exchange Commission, so they can expect the costs just mentioned to increase some three- or four-fold. The combined costs to the holding companies and to the Federal Reserve System of complying with requirements of the Bank Holding Company Act are not trivial. For 1978, the last year for which complete data are available, they have been estimated to be running around $30 million per year, about equally divided between the holding companies and the Federal Reserve.

The question that, I am sure, comes to your mind is what has been gained by an expenditure of resources of this magnitude? How is the public better off as a result of this compliance and enforcement burden? Let me assure you that policymakers within the Federal Reserve have been equally concerned with this issue. And, let me also assure you that enforcement of the Bank Holding Company Act has generated benefits to the public that have exceeded the costs of the Act. For example, the Board has denied dozens of applications that would have eliminated competition between two banks in the same market. Harvey Rosenblum's research indicates that the benefits to bank customers in the form of lower priced bank services, just from those denials of applications that would have eliminated existing competition, has been more than sufficient to outweigh all other costs associated with the Act.

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The Board has also been concerned with holding company acquisitions of leading banks in markets where it could enter by more procompetitive means, such as by chartering a de novo bank or by acquiring one of the smaller banks in the market. The Board has denied several such potential competition cases in the last six months. The Board has not limited its concern with anticompetitive effects to multibank holding companies; in May 1977, it began to treat chain banking organizations as de facto multibank holding companies and has denied the private benefits of the holding company organizational form to one-bank holding companies whose existence would further an anticompetitive arrangement. Public benefits have also been generated by the Board's insistence that when competitive effects are slightly adverse, the holding company must make some commitment to provide services or alter prices charged by the acquired bank so that the public will be better off from the acquisition. And we follow up to see that those commitments are met.

Finally, as I mentioned earlier, the Board also must evaluate the impact of the holding company on the safety and soundness of its subsidiary bank(s). The Board's main concern in this area has been with the use of excessive debt at the holding company level and the consequent strains on the bank affiliate to help in servicing that debt, year-in and year-out, in good times and bad. While the Board has recently relaxed its debt standards somewhat for small one-bank holding companies, the Board has in no way relaxed its commitment to maintain the safety and soundness of affiliate banks and will continue to look askance at holding company proposals that may entail difficulty in debt servicing, particularly if it would impair the capital accounts of the bank subsidiary.

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I might add that, as with most regulations, the costs of the Bank Holding Company Act are imposed upon all those who must comply, not just on those few whose abuses gave rise to the need for regulation in the first place. But, unlike many other laws and regulations on the books, it appears that for the Bank Holding Company Act, the benefits of regulation outweigh the costs.

I have tried to convey to you the flavor of bank holding company regulation. The Federal Reserve has a public policy role to play and a broad concern for the public interest that must transcend your concerns as directors or stockholders in a holding company. We in the Federal Reserve are aware of the costs we impose on holding companies and have attempted to keep those costs to a minimum consistent with the public role we must play. Furthermore, the costs imposed by holding company regulation have not been sufficient to outweigh or stifle the creativity and advantages stemming from the bank holding company organizational form.

The holding company organizational form offers financial, product, and geographical flexibility that is beyond the reach of an individual bank. The fact that the holding company movement has continued to increase in popularity shows, I think, that the Federal Reserve has allowed this flexibility to work to the public's good. I hope you agree.

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