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Statement of

William McChesney Martin, Jr.,

Chairman, Board of Governors of the Federal Reserve System,

before the

Subcommittee on Financial Institutions

of the

Senate Committee on Banking and Currency

on

S. 2353, S. 2418, and H.R. 7371

March 16, 1966

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The Bank Holding Company Act of 1956 has two chief objectives. The first is to prevent undue concentration of control over banks in the hands of any holding company, and the second is to prevent any holding company from controlling both banks and nonbanking businesses. The Act prohibits formation of a bank holding company without the approval of the Board of Governors of the Federal Reserve System, and prohibits existing bank holding companies from acquiring more than 5 per cent of any bank's voting shares without the Board's approval. It also prohibits a bank holding company from engaging in any business other than banking, or acquiring more than 5 per cent of the voting shares of any such business, and requires the holding company to divest any such interests previously acquired. In addition, it prohibits any subsidiary bank from lending to or investing in its parent holding company or any other subsidiary.

The principal issue presented by the bills before you this morning relates to the coverage of the Bank Holding Company Act. For every holding company now registered under the Act, there are 10 or more that are exempt, chiefly because the Act does not cover "one-bank" holding companies. The Board sees no basis in logic or equity for this exemption, and recommends its repeal.

While there would obviously be no need for the Act to cover one-bank holding companies if its only purpose were to prevent any holding company from acquiring too many banks, it seems just as clear that coverage of one-bank holding companies is necessary to accomplish

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the Act's second objective. In this connection, let me quote from this Committee's 1955 report on the Act:

> " * * * bank holding companies should confine their activities to the control and management of banks and activities closely related to banking. They should not combine management and control of banking activities with management and control of nonbanking activities. The divestment requirements in this bill are designed to remove the danger that a bank holding company might misuse or abuse the resources of a bank it controls in order to gain an advantage in the operation of the nonbanking activities it controls." (S. Rept. No. 1095, 84th Cong., 1st Sess., pp. 13-14)

Abuses could come about "by requiring the bank's customers to make use of such nonbanking enterprises as a condition of doing business with the bank," as the committee report pointed out (p. 5), or they could take the form of denying credit to competitors of the bank's fellow subsidiaries. When a builder seeks a construction loan from a bank, the loan should be made or denied without regard to whether the applicant will buy his lumber from a supplier that is owned by the same holding company that owns the bank. When an automobile dealer seeks to discount his customers' paper at a bank, the bank's decision should not be complicated by questions of how it will affect the competitive position of another automobile dealership owned by the bank's parent company. If a holding company is a finance company, the bank's decisions as to whether it should make automobile loans directly should not be influenced by considerations as to whether its activities would take business away from its parent finance company.

If you ask whether the Board can cite specific examples of such abuses among the hundreds of one-bank holding companies in existence

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today, the answer is "No." Presumably, the organizers of these companies are neither more nor less scrupulous than their counterparts in other businesses. But for companies now registered under the Act, no proof of actual abuses was required. The Congress decided, and the Board agreed, that even in the absence of such proof, the potentiality for abuse in the relationships between holding company, bank subsidiary, and nonbank subsidiary was sufficiently great to require divestment of nonbank businesses. The Board believed then, and continues to believe, that this is just as true for one-bank holding companies as for two-bank companies. We subscribe to another principle laid down in your Committee's report, that "in general all bank holding companies should be required to observe the same ground rules concerning formation and operation, insofar as Federal legislation is concerned." (id. at p. 14)

While it may be argued that multi-bank holding companies should be treated differently from one-bank holding companies because their operations have a greater impact on our economy, the facts are that a finance company with assets of three billion dollars now controls a single bank with deposits of three quarters of a billion dollars; the total deposits of the banks shown on the list of one-bank holding companies recently published by this Committee is about fifteen billion dollars compared with about twenty-six billion dollars for the subsidiary banks of all registered bank holding companies. Moreover, about one-fourth of the one-bank holding companies on the list are found in one-bank towns. In such situations, it is particularly desirable that the bank's credit decisions be based solely on creditworthiness.

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Let me turn now to questions of what kinds of organizations should be included in the definition of "company." At the outset, it may be asked why the Act now covers only companies, and does not apply to control exercised by an individual. It is, of course, possible for an individual to achieve the sort of domination of a banking market that the Act seeks to prevent a company from obtaining. The same conflicts of interest could also arise where an individual controls a bank and a nonbanking business. But the need to regulate this kind of activity on the part of individuals is not as great as it is for corporations, because individuals generally are more limited than are corporations in their ability to attract capital for expansion, and because control by individuals generally is diffused when they die.

The decision to cover corporations but exempt individuals entails some difficulty in deciding whether to cover holdings by groups of individuals associated together in some form other than a corporation. The Act now covers many such forms of association by defining "company" to include (with certain exceptions) "any corporation, business trust, association, or similar organization." It excludes partnerships, however. The Board is not aware of any need to disturb this exclusion. Admittedly, there are exceptions to the broad generalizations that corporations have longer lives, and obtain capital more easily, than partnerships. But the Board is inclined to believe that the same reasons that support an exemption for individuals also support--though to a lesser degree--the exemption for partnerships.

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The next question arises when an individual extends his control over banks beyond his death, as is commonly done through testamentary trusts established for the benefit of a widow or children. The Board sees good reason to exempt the ordinary family trust, which may be regarded as only a temporary extension of the control originally exercised by the individual who established the trust. But when a will creates a trust that is perpetual, with trustees who are not only replaceable but are authorized and indeed obliged to manage the trust's affairs so that it may grow and prosper, the Board believes that the line between control by individuals and control by corporations has been crossed, and that such a trust should be subject to the Act just as a corporation should. Again, it is not easy to draw a line between trusts that should be exempt and those that should be covered. We believe after further study that the provision we originally suggested, which is now incorporated in S. 2353, would probably cover some family trusts that should be exempt, such as a trust for the benefit of surviving children who might not be "named" in the trust instrument. We now suggest, therefore, that the bill be amended to exclude from coverage trusts that must terminate within twenty-one years after the death of individual beneficiaries living when the trusts become effective.

By far the largest trust that would be covered by the bills before you is that established in 1936 under the will of Alfred I. du Pont. In testimony before the House Banking and Currency Committee last year, Edward Ball, cotrustee of the du Pont Estate, described the effect of Mr. du Pont's will as follows:

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"In that will, after making some preliminary bequests, he established a testamentary trust, appointed trustees, and made his wife the beneficiary of the income from that trust as long as she lived. Mrs. du Pont is 81 years old. Upon her death, all of the income from the trust properties will be paid to the Nemours Foundation, which is the beneficiary of the trust. The Nemours Foundation is a tax-exempt, charitable foundation and provides care for crippled children, not incurables, and aged men and women. * * * It is a trust in perpetuity, and it is a charitable trust." (Hearings on H.R. 7371, p. 44)

According to Mr. Ball's 1964 testimony before the same Committee, the Nemours Foundation is a corporation, created in 1937, which embarked upon its charitable function with $1 million paid over to it from the du Pont Estate. "Mrs. du Pont has made an irrevocable assignment of 12 percent of her income from the estate to the Nemours Foundation," Mr. Ball added. "Last year (1963) this amounted to $1,007,026.71. Upon her death, the additional 88 percent, which last year amounted to $7,384,862.57, will go to the foundation." (Hearings on H.R. 10668 and H.R. 10872, p. 227)

The testimony further indicates that when the Bank Holding Company Act was enacted, the estate controlled 24 banks and 5 nonbanking enterprises, doing business in real estate, insurance, safe deposit box rentals, small resort operation, and the manufacture of paper and pulp products. One of the five nonbanking corporations, the St. Joe Paper Company, owned 100 per cent of the stock of six other companies--including a railroad, a telephone and telegraph company, and a warehousing company--and 50 per cent of the stock of a corporation that manufactured cardboard containers. It also owned 52 per cent of the defaulted bonds of the Florida East Coast Railway Co., in receivership at the time. The railroad emerged from receivership in 1961, under the control of the estate. The

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banks in the Florida National group controlled by the estate expanded from 24 in 1956 to 31 last year; the number has now dropped to 30. These banks are listed on page 7 of the Committee Print of February 1966, listing the organizations covered by S. 2353.

A handful of other trusts are included in the published list. They include some employee-benefit trusts, which presumably are perpetual, and a few perpetual charitable trusts. We know very little about these trusts, and it is possible that some of them should not be on the list. In the survey we conducted at your Chairman's request, on which this list is based, many other banks reported that 25 per cent or more of their voting shares were held by trustees, but it is impractical to investigate each of these instances to determine whether the trust would be covered under the proposed amendment.

One of the bills before you, S. 2418, provides that where two trusts have a common beneficiary or trustee they shall be presumed to control each other unless the Board determines that the presumption should not apply. While this provision seems unnecessarily broad, the Board recognizes that coverage of trusts poses special problems in connection with the divestiture requirements of section 4 of the Act, and that some provision may be needed to prevent a token divestment to a newly created trust controlled by the same trustees. We recommend that you consider amending section 4 by adding a provision to the effect that divestment to any trust having one or more trustees in common with the divesting trust shall not be considered as an effective divestment.

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If the Committee agrees that long-term trusts should be covered, conforming amendments will be required, as indicated in the attachment at the end of my statement.

The third principal change in coverage recommended by the Board is to delete the present exemption for registered investment companies and their affiliates. This exemption is now enjoyed exclusively by the Financial General Corporation, a company that is not, itself, registered under the Investment Company Act of 1940, but is affiliated with Equity Corporation, a registered company. The Board does not agree with the contention that because companies registered under the 1940 Act are supervised by the Securities and Exchange Commission there is no need for regulation under the Bank Holding Company Act. The SEC has no authority to prevent an affiliate of a registered investment company from expanding its control over banks or combining banks with nonbanking businesses. SEC supervision of such affiliates is for an entirely different purpose, and is limited to dealings between the affiliate and the registered investment company.

Financial General now owns one subsidiary, Empire Shares Corporation, which is a registered bank holding company owning three banks in New York. In addition, Financial General owns 18 other subsidiary corporations, each of which owns one bank; two of these banks are in the District of Columbia, one in Georgia, four in Maryland, one in Tennessee, and 10 in Virginia. Nonbanking interests of Financial General include firms engaged in life insurance, fire and casualty insurance, industrial and manufacturing activities, lease financing, and mortgage banking.

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Financial General is exempt from the Bank Holding Company Act because of a provision in section 2(a) excluding from the definition of "bank holding company" any company "which is registered under the Investment Company Act of 1940, and was so registered prior to May 15, 1955 (or which is affiliated with any such company in such manner as to constitute an affiliated company within the meaning of such Act), unless such company (or such affiliated company), as the case may be, directly owns 25 per centum or more of the voting shares of each of two or more banks." Under the Investment Company Act two companies are "affiliated with" each other if either owns as much as five per cent of the other's stock. Financial General is "affiliated with" Equity Corporation, because the latter owns approximately 15 per cent of Financial General's stock. Neither Equity nor Financial General "directly" owns 25 per cent of the stock of any bank, because in each case the bank stock is held by a separate holding company that is a subsidiary of Financial General.

This exemption has enabled Financial General not only to continue to operate banks and nonbank businesses, but also to expand its banking interests considerably since enactment of the Bank Holding Company Act. The company's latest annual report observed that it "is now the largest interstate banking group in the East, and sixth largest banking group in the United States." Of the 21 banks under its control, 15 have been acquired since enactment. This expansion took place in several different States, despite the fact that Financial General's principal place of business is in the District of Columbia. For companies covered by the Act, acquisitions of a bank outside the holding company's home State are

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prohibited unless the acquisition is "specifically authorized by the statute laws of the State in which such bank is located, by language to that effect and not merely by implication."

Although only one company has thus far taken advantage of this exemption, it is available for use by others. Any company wishing to take advantage of this loophole may do so by acquiring five per cent of the stock of any of the roughly 300 investment companies that were registered before May 15, 1955. The Board believes that this possibility for escaping regulation under the Act should be eliminated by repeal of the exemption.

The Board also believes that nonprofit corporations engaged in charitable, educational, or religious activities should not be permitted to acquire banks free of regulation, or to combine banking and nonbanking businesses. We see no reason to assume that organizations of this kind are immune, because of their nature, from the potentialities for trouble that exist in the case of ordinary business corporations. The Board accordingly recommends repeal of the exemption for charitable, educational, and religious organizations now included in section 2(b)(2) of the Act.

The original Bank Holding Company Act included tax provisions designed to make sure that those who are forced to dispose of property because of the divestment requirements of the Act will not suffer unfavorable tax consequences. The Board believes that this same principle should apply to divestitures required as a result of the amendments now under consideration.

In addition to a broadening of the Act to cover holding companies that are now exempted, the Board recommends changes with respect

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to dealings between subsidiary banks and their parent holding companies or fellow subsidiaries. Section 6 of the Act prohibits any "upstream" or "cross-stream" loans or investments by a subsidiary bank--"upstream" meaning from the bank to the holding company, and "cross-stream" meaning from the bank to another subsidiary (which must, under the Act, be another bank or closely-related business).

The Board believes that this prohibition is too rigid, in that it prevents some portfolio adjustments between subsidiary banks that are legitimate and economically beneficial. We recognize the need for limits on upstream and cross-stream credit, and believe that this can be accomplished readily by applying section 23A of the Federal Reserve Act. Section 23A prohibits any bank that is a member of the Federal Reserve System from extending credit (through loans or investments) totaling more than 10 per cent of its capital and surplus to any one affiliate, or more than 20 per cent for all affiliates. We recommend that this limitation be applied to all insured banks (whether or not they are members of the Federal Reserve System) and that the definition of "affiliate" be broadened to cover bank holding companies and their subsidiaries.

These are the principal changes involved in the bills before you. All three bills would cover long-term trusts and repeal the exemption for registered investment companies and their affiliates. In addition, all three bills would repeal the exemption for nonprofit charitable, religious, or educational organizations. S. 2353, introduced by your Chairman at the Board's request, and H.R. 7371, which passed the House of Representatives last September, would also repeal an exemption for agricultural companies that is probably meaningless now although it was

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designed in 1956 to cover a special case, and would repeal two other special exemptions from the requirement that bank holding companies must divest their interests in nonbanking businesses. One of these exempts certain labor, agricultural, and horticultural organizations from the divestment requirement. The other allows a bank that is also a holding company to keep nonbank stock it owned before the Act was enacted. In sum, the Board recommends, and the House of Representatives has approved, extending coverage under the Act in seven respects. Three of these changes are incorporated in S. 2418. The different effects of the three bills as to coverage are shown on page 2 of the Committee Print published by your Committee in November of 1965.

In addition, S. 2353 would, as I have explained, substitute limitations on "upstream" and "cross-stream" credit for the prohibitions now contained in section 6 of the Act. S. 2353 also includes a number of other amendments which are largely technical. These are explained in the memorandum that accompanied my letter to your Chairman submitting the legislation; this memorandum is reproduced in the November 1965 Committee Print. Rather than taking your time now to go through the technicalities of these changes, perhaps I can best assist you by responding to questions you may have regarding the three bills.

Attachment

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ATTACHMENT

Technical Amendments to S. 2353

On page 5, strike line 24, and on page 6, strike lines 1 through 4, inclusive, and insert in lieu thereof the following:

(b) The second sentence of subsection (a) of section 3 of the Bank Holding Company Act of 1956 (12 U.S.C. 1842(a)) is amended by striking the words "for the benefit of the shareholders of such bank" at the end of clause (i) and inserting in lieu thereof the words "under a trust that constitutes a company as defined in section 2(b)".

On page 7, strike lines 20 through 23, inclusive, and insert in lieu thereof the following:

"(4) shares held or acquired by a bank in good faith in a fiduciary capacity, except where such shares are held under a trust that constitutes a company as defined in section 2(b);"

Explanation: Section 2 of S. 2353 would broaden the definition of "company" to include long-term trusts. The technical amendments above are conforming amendments, to make sure that the exemptions now contained in section 3(a) and section 4(c) of the 1956 Act for shares held by a bank in a fiduciary capacity will not be construed to exempt any long-term trust where the trustee is a bank. These exemptions are needed to permit banks to continue to hold shares of stock in banks and other companies in the course of their trust business, but they should be limited to short-term trusts, such as those established by will to take care of the spouse and children of the testator.

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