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Statement by

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before the

Committee on Banking and Currency

House of Representatives

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When I appeared before this Committee last September, I reported to you that the Board of Governors was deeply concerned about the rapid increase in formation of one-bank holding companies, and I expressed the view that this development, if unchecked, could affect the whole economic system of the United States. Since that time, encouraging progress has been made toward legislation to regulate one-bank holding companies in the public interest. In weighing different approaches, we should not overlook the very wide area of agreement in Government and in the banking industry on the need for a bill, and on the general outlines it should take. The Board appreciates the prompt action being taken by this Committee, and we find much with which we can agree in both H. R. 6778 and H. R. 9385.

Unquestionably there is broad support for the view that bank holding companies should be congenerics, not conglomerates. The Congress took steps years ago, in the Banking Act of 1933, to separate banking from nonbanking businesses, a policy that was reinforced by the Bank Holding Company Act of 1956 as to companies that own two or more banks. Under section 4 of the 1956 Act, such companies are limited to banking and closely related activities. The Board unanimously agrees that there are sound reasons for separating banking and commerce, and that it is essential, if this policy is to continue, to bring one-bank holding companies under the Holding Company Act.

And all members of the Board agree that public benefits in the form of greater convenience, gains in efficiency, and keener competition should flow from encouraging innovation by one-bank holding companies as well as multibank holding companies in offering services to the public. In determining whether a bank holding company should be authorized to engage in a particular activity, the prospects of realizing such benefits must be weighed against the risks of perverse consequences that led Congress to separate banking from other businesses.

To my mind, the greatest risk is in concentration of economic power. If a holding company combines a bank with a typical business firm, there is a strong possibility that the bank's credit will be more readily available to the customers of the affiliated business than to customers of other businesses not so affiliated. Since credit has become increasingly essential to merchandising, the business firm that can offer an assured line of credit to finance its sales has a very real competitive advantage over one that cannot. In addition to favoring the business firm's customers, the bank might deny credit to competing firms or grant credit to other borrowers only on condition that they agree to do business with the affiliated firm. This is why I feel so strongly that if we allow the line between banking and commerce to be erased, we run the risk of cartelizing our economy. My concern is that just as we have seen the country's largest banks joining the new wave of one-bank holding companies, we could later see the country's business firms clustering about banks in holding company systems in the belief that such an affiliation would be advantageous, or perhaps even necessary to their survival.

This is, of course, an antitrust problem, not simply a banking problem. But I do not think it follows that it should be left to the antitrust laws rather than the banking laws. I hesitate to comment about an area in which others, particularly Assistant Attorney General McLaren, are more competent to speak. But I see no reason to rely solely on case-by-case litigation under the antitrust laws to prevent affiliations between banks and business where a strong anticompetitive potential exists. In the Bank Holding Company Act, the Banking Act of 1933, and section 8 of the Clayton Act--to cite a few examples--the Congress has chosen, instead, to prohibit outright particular kinds of affiliations involving banks, largely because of concern over preserving competition.

Considerations of safety and soundness reinforce the policy of separating banking and other businesses. A bank should be insulated from pressures that might lead it to favor customers of affiliated businesses in its credit decisions. Otherwise, the bank might build an unbalanced loan portfolio by discounting an excessive amount of obligations of such customers, or a low-quality portfolio by accepting substandard risks to foster sales to such customers. An essential part of the traditions of bank management has been a scrupulous observance of the need for prudence in handling funds entrusted to the bank by its customers; if management were to become oriented toward the different objectives of other businesses, this tradition could be seriously weakened.

Section 23A of the Federal Reserve Act now affords a considerable measure of protection against excessive extensions of credit by a bank directly to any of its affiliates. Broadly speaking, section 23A limits such credit to 10 per cent of the bank's capital and surplus for any one affiliate, and to 20 per cent for all affiliates. And it requires that credit to affiliates be secured by adequate collateral. But section 23A does not apply to credit extended to customers of affiliates, and so it is ineffective in protecting against the risks I have been discussing. It probably is not feasible to draft legislation that would deal adequately with the many subtle but powerful pressures that would arise in those areas if banks had many commercial affiliates.

In addition to the effect on competition and on sound banking, we should bear in mind a problem that has appeared from time to time throughout the history of holding companies of all kinds. That is, there is a risk that the management of the holding company may become more interested in obtaining access to larger and larger pools of funds for greater and greater expansion than in the efficient operation of the subsidiaries. Holding companies at times in the past have accepted the lure of operating and reporting so as to influence the company's current stock price rather than its long run profitability. I am happy to report that holding companies now registered under the Bank Holding Company Act have not engaged in these practices or the kinds of pyramiding and watering of stock that led to the collapse of some earlier holding companies. On the contrary, in general they are soundly capitalized, without unnecessary complexity in their capital structures, and their fixed obligations bear a reasonable relationship to equities. The principal reason, we can assume, is that responsible and capable people have been in control of the registered bank holding companies. But in addition the Board has been able to exercise a healthy influence over the financial structure of these companies in passing upon applications under the Act. Prudence suggests that similar precautions should be taken for one-bank holding companies.

Just as there is wide agreement that bank holding companies should not be conglomerates, there is also general acceptance of the view that public benefits may be derived from allowing banks to join holding company systems engaged in what may be called "related" or "congeneric" activities. These terms are hard to define, and they mean different things to different people. But I use them in the sense of services that are functionally related to the activities of banks in such a way that the combination will offer benefits to the public in the form of lower costs or better service. I do not mean to suggest that all such activities should be automatically authorized. Rather, there should be safeguards, which I will return to later, designed to ensure that entry by bank holding companies into these areas will increase competition rather than lessen it.

Combining banks with related businesses may lead to economies of scale in production, distribution, sales, research, and finance. In the production area, economies of scale will depend mainly on the similarity of the services offered, such as servicing a checking account and processing a payroll. People appreciate the convenience of being able to buy insurance on a new car at the same time they arrange for bank financing; combining the two services also may lower sales costs. A research staff, too expensive for a bank alone, can pay dividends when the expenses and services are shared with others in a holding company system. And a holding company may be able to obtain capital less expensively by going to market less frequently than any of its smaller components.

Section 4 of the Bank Holding Company Act prohibits a bank holding company from acquiring shares of any company which is not a bank. There are ten exceptions to this general prohibition, one of which, section 4(c)(8), permits acquisition of shares of any company all of whose activities are of a financial, fiduciary, or insurance nature and which the Board, on the basis of a hearing, has determined to be so closely related to the business of banking, or of managing or controlling banks, as to be a proper incident thereto and as to make it unnecessary for the prohibitions of section 4 of the Act to apply in order to carry out the purposes of the Act.

On the basis of the language of the statute and its legislative history, the Board has interpreted the 4(c)(8) exemption to mean that there must be a direct and significant connection between the proposed activities of the company to be acquired and the business of banking, or of managing and controlling banks, as conducted by the bank holding company or its banking subsidiaries. For example, section 4(c)(8) has been interpreted to authorize bank holding companies to acquire subsidiaries that issue insurance or act as insurance agents where the insurance is related to the business of subsidiary banks, as shown by percentages of premium income derived from insurance written in connection with bank transactions or for bank customers. In those cases in which the Board has interpreted section 4(c)(8) as permitting a bank holding company to establish a subsidiary "insurance company," as distinguished from an insurance agency, 100 per cent of the insurance was written in connection with loans by the subsidiary banks. The acquisition by a bank holding company of a subsidiary conducting a general insurance underwriting business is prohibited.

The Board believes that a bank holding company should be permitted to acquire a subsidiary, subject to regulatory approval and supervision, to engage in "related" activities without showing such a close connection between the business and that of a subsidiary bank. Permissible acquisitions might include, for example, companies engaged in the business of lending funds on their own account; investing in equities, subject to careful limitations, to assist in the economic development of low-income areas or to meet other pressing needs for financing that cannot be met adequately through debt instruments; acting as insurance agent or broker or as insurer in connection with extensions of credit by other subsidiaries of the holding company; providing accounting or data processing services; acting as fiduciary; and acting as travel agent.

Bank holding company acquisition of companies engaged in most of these activities is now permissible to some extent, under section 4(c)(3) or under other paragraphs of section 4(c). But section 4(c)(8) requires that a formal hearing be held before a hearing examiner on each application thereunder, even in the absence of any interest or testimony by anyone other than the applicant. This is a time-consuming and expensive procedure, which should be limited to instances where a hearing is requested by an interested party. And as I mentioned, we believe that section 4(c)(8) should be amended to eliminate the reference to close relationship of the proposed activity to the business of the subsidiary banks, which we regard as unnecessarily constricting.

I mentioned earlier that expansion of activities by bank holding companies should be subject to safeguards. After it has been decided that a particular activity is "related" or "congeneric," administrative approval should be required before a holding company may establish a subsidiary to engage in the activity. Guidelines governing such approval should take into account the competitive and other factors already specified in the Act as to acquisitions of banks. Approval should be required whether the expansion is by establishing a new company or acquiring an existing one, but it should be recognized that the probability of anticompetitive consequences appears greater in acquisitions of existing concerns than in de novo entry. Another reason to favor de novo entry over acquisitions of established businesses is that a company newly entering a market to face the competition of those already in it must meet the test of efficiency that such a market imposes. And an applicant proposing an acquisition involving a relatively large amount of nonbank assets should ordinarily bear a greater burden of proving that the acquisition is not contrary to the public interest.

Another safeguard which should accompany expansion of bank holding company activities is a prohibition against so-called "tie-in" arrangements. Where a bank holding company may achieve economies of scale by combining one service with another, an opportunity may also be presented to force sales of one service upon customers who wish to buy the other. We understand that such forced sales are already prohibited by the Sherman Act, but probably not the Clayton Act, since the relevant provision of that Act (section 3) relates to commodities rather than services. In any event, we believe that any ambiguity as to the applicability of such laws to the services offered by banks and their affiliates should be eliminated. We prefer the language of H. R. 6778 to that of H. R. 9385 on this point, since H. R. 6773 would retain the traditional tests of anti-competitive effects and would apply to all insured banks, whether or not they are subsidiaries of holding companies.

I want to say a few words now about the problem of holding companies that have been in existence for some time. The Board recognizes that the Congress in the past has felt that coverage of one-bank holding companies would conflict with the objective of fostering local ownership of small unit banks. Until quite recently, the overwhelming majority of one-bank holding companies owned small banks, which were combined with even smaller interests in nonbanking businesses.

When the Bank Holding Company Act was under consideration in the early 1950's, the Board recommended that the principle of limiting the activities of bank holding companies to fields closely related to banking should apply to holding companies that own only one bank as well as to those that own two or more. The Congress disagreed, and exempted one-bank holding companies. Again in 1966, the Congress rejected a House-passed amendment that would have covered one-bank holding companies. The Senate Committee report expressed concern over the possibility that "repeal of the exemption would make it more difficult for individuals to continue to hold or to form small independent banks," adding that "repeal of the exemption would, therefore, be likely to result in causing the forced sale of large numbers of banks and in a diminution of competition rather than an increase in competition."

Since then, of course, the situation has changed drastically. No longer is the one-bank exemption a minor exception to a general rule. The assets of one-bank holding company banks now exceed those of the banks covered by the Act. The exemption has become a loophole of such magnitude that unless it is closed there is no possibility of effectively enforcing the Act's restrictions on combining non-banking businesses with banking through holding companies.

One way to close this loophole without making it more difficult to hold or form small independent banks, and without forcing the sale of large numbers of such banks--the concerns expressed in the Senate committee report in 1966--would be to exempt small holding companies. An exemption for companies with banking assets of less than $30 million and nonbank assets of less than $10 million would not seriously weaken the protection this legislation is designed to provide, while it would recognize that divestiture would be particularly difficult for small, closely-held holding companies. Imposing a smaller limit on nonbanking assets than on banking assets would offer reasonable assurance that this exemption would not be exploited by those whose principal motivations were to advance their interests in nonbanking businesses. At the same time, it must be recognized that there is an element of arbitrariness in drawing a line at $30 million, or any other figure. About 85 per cent of the one-bank holding companies in existence last September 1 had deposits of less than $30 million.

An alternative approach would be to base the exemption not on size but on date of acquisition--a "grandfather" clause. A majority of the members of the Board prefer this approach; it is the approach taken by H. R. 9385. A "grandfather" clause poses administrative problems, particularly in determining whether a "grandfather" company is engaging only in those activities in which it was engaged on the cutoff date. But we can hope that the problems will be manageable. And we can see that the larger one-bank holding companies that were in existence for some time before the recent wave of new formations began (generally accepted as July 1, 1968) may legitimately claim that they are entitled to special consideration as well as the small companies.

I come now to the difficult question of where responsibility for regulating one-bank holding companies should be lodged. The Board believes that it would be most effective for one agency (preferably the Board) to administer the Bank Holding Company Act with respect to the holding companies themselves and with respect to the approval of acquisitions by them. Holding companies are not banks. As I mentioned earlier, supervision of holding companies entails considerations that extend well beyond those involved in supervising banks. The proposed changes in section 4(c)(8) will be breaking new ground. Under the best of circumstances, an orderly move into new spheres for holding company activity will be difficult. The development of these new areas by unanimous agreement of three different agencies on complex ground rules is apt to prove slow and cumbersome. And it is hardly the best way to achieve the uniformity needed for competitive equality. The Board believes that the existing precedent established in 1956 under which bank holding companies are supervised by the Board would ensure the greatest efficiency and equity.

Alternatively, and less desirably, authority over one-bank holding companies might be dispersed among the three banking agencies with a requirement that regulations be jointly promulgated as to permitted nonbank lines of activity and containing guidelines as to acquisitions which would be presumed to be against the public interest. These regulations should also be applicable to nonbank acquisitions by multibank holding companies. Such an arrangement would be acceptable to a majority of the Board.

While we believe that vesting in the Board or another Government agency exclusive authority to administer all phases of the Bank Holding Company Act would best serve the interest of administrative efficiency, we recognize that others are more impressed with the arguments for dispersing this authority in the traditional banking pattern. You can judge better than I whether the desire for dispersal is strong enough to block legislation that would vest authority over one-bank holding companies exclusively in the Board. But in view of this possibility, I should point out that most Board members believe that the need for this legislation is too pressing to allow its passage to be jeopardized by considerations of administrative efficiency. It seems clear to the majority of the Board that it would be better to enact a bill incorporating the administrative provisions of H. R. 9385 than to wind up with no bill at all.

Let me now review briefly the Board's recommendations as to other provisions of the two bills.

We favor broadening the tests of control, as both bills would do, to cover situations where control is exercised in fact through ownership of less than 25 per cent of the voting stock. To assist in such determinations, we recommend that you include provisions establishing a rebuttable presumption that control exists where a company (1) owns 10 per cent of the voting shares of two or more banks or (2) owns 5 per cent of the voting shares of three or more banks.

In view of the recent use of the partnership form to bring several banks in Michigan and one in the District of Columbia under common control, the definition of "company" should be extended to cover partnerships.

H. R. 6778, as we read it, would require a bank that held in its trust department a controlling interest in the stock of another bank to register and file reports under the Act; but such a bank could continue to acquire stocks of other banks in a fiduciary capacity without Board approval, in view of the exemption in section 3 of the Act, which would be retained. The Board believes that something beyond registration and reporting is needed to assure that acquisitions through trust accounts are not used to avoid the limitations the Act imposes on concentration of banking. Outright repeal of the exemption in section 3, however, would interfere too drastically with banks' ability to offer needed fiduciary services. We recommend, instead, that the exemption in section 3 be limited, as to bank stock, to cases where the trustee bank obtains voting instructions from the beneficiary, thus following the precedent established in section 5144 of the Revised Statutes as to national banks' voting their own stock held in trust.

We also recommend elimination of another exemption in section 3 of the present Act. It now permits a bank holding company to acquire up to 5 per cent of the stock of a bank without Board approval. Since a holding company may obtain a significant influence over a bank, without actually controlling it, by buying less than 5 per cent of its stock, we believe the purposes of the Act would be better effectuated if every acquisition of bank stock by a holding company required prior approval of the Board. Accordingly, we recommend elimination of the 5 per cent exemption in section 3.

H. R. 9385 would prohibit any one-bank holding company from retaining any bank acquired after March 1, 1969, unless retention is approved under the new legislation. Such a provision should prove useful in forestalling a possible race to acquire banks before regulatory legislation can be enacted.

The provisions of H. R. 9385 allowing one-bank holding companies to continue to acquire nonbanking businesses if they divest their bank by June 30, 1971 (with possible extensions to June 30, 1974) seem a reasonable extension of the principle already incorporated in section 4 of the Act. Section 4 now allows two years (with possible extensions up to five years) for a holding company to divest either its banks or its nonbanking businesses. Those one-bank holding companies that choose to divest their bank and keep their nonbanking businesses should be allowed to expand while they are in the process of divesting the bank.

H. R. 6778 would repeal the exemption for labor, agricultural, and horticultural organizations in section 4(c) of the Act; the Board has repeatedly recommended that this be done.

We also recommend that the exemptions in sections 4(c)(5) and 4(c)(9) be amended as provided in H. R. 9385 so as to preclude the possibility that a bank might establish a holding company to acquire a foreign bank without obtaining Board approval, which would be required under section 25 of the Federal Reserve Act if the bank made the acquisition directly.

H. R. 6778 would also transfer to the Board jurisdiction over all mergers where the resulting bank is a subsidiary of a holding company. As we did in 1966, the Board favors transfer of such jurisdiction as to holding companies that control two or more banks. H. R. 6778 would also prohibit any merger of a subsidiary bank outside the holding company's home state; we suggest that prohibition be relaxed to allow such a merger where necessary to save a failing bank. We recommend against transferring the other matters referred to in H. R. 6778 (reductions in capital of a nonmember insured bank in a holding company system and conversions by a subsidiary national bank to a nonmember insured bank).

Section 2(f) of H. R. 6778 would require insured banks to file quarterly reports with SEC listing securities held in trust accounts. We believe that action in this area should be postponed until the matter can be handled uniformly and comprehensively after SEC completes its current study of the activities of institutional investors.

The remaining provisions of H. R. 6778 prohibit interlocking relationships among insured banks, insurance companies, and securities brokers and dealers. The Board now administers the prohibition against interlocking relationships between a member bank and another bank (section 8 of the Clayton Act) and between a member bank and a securities company (section 32 of the Banking Act of 1933). We think limitations on interlocking relationships between competing institutions are salutary and the existing provisions are deficient in a number of respects; for example, we see no reason to limit them to member banks, or to banks in the same town or adjacent towns. We favor expanding the scope of the prohibitions against interlocks to include the classes of institutions set forth in H. R. 6778, although we see no reason to apply such prohibitions to persons engaged exclusively in the brokerage business. We think some agency should be authorized to exempt classes of cases where the risks would be slight, such as where the companies involved are neither actual nor potential competitors. And as to interlocks between a bank and a securities company, we think an exemption (as is now provided in section 32 of the Banking Act of 1933) should be authorized for classes of relationships that would not result in undue influence of the investment policies of banks or the advice they give their customers regarding investments.

I have dealt with these numerous details in order to be as responsive as I can to the variety of issues posed by the proposed legislation and the developments to which it is addressed. In closing, however, I want to reemphasize the basic purpose of the bill. It would be lamentable if protracted wrangling over the many subsidiary points in this matter bogged down the legislative process. To forestall holding company developments that will be increasingly painful to reverse, we need a law now--as good a one as can reasonably be devised--bearing in mind that it can be revised later if necessary in the light of experience.

I know you gentlemen are aware of these considerations, and I want to express the Board's deep appreciation for the active interest this Committee has shown in seeking a timely and constructive solution to what is a complex and pressing problem. For our part, the Board will be glad to do anything it can to facilitate your efforts to move such legislation through the Congress.