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1 World Energy Shortage Produces Severance Tax Windfall for Texas

7 Joint Policy Established for Examination of Data Centers

9 Bank Holding Company Study Completed

15 Federal Reserve Regulations to Be Streamlined

16 Commercial Loan Charge-offs

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World Energy Shortage Produces Severance Tax Windfall for Texas

By Edward L. McClelland

Lower taxes are an important reason that Texas is gaining population and industry faster than other states. Texas is the only large state that has neither a corporate nor a personal income tax, and excluding severance taxes, it ranks 49th in per capita taxes paid to the state government. State taxes paid by the average Texan were $273 in 1976, compared with $233 in New Hampshire, the lowest state, and $408 for the average American.

One reason for the low tax burden on individuals is that Texas ranks 48th in per capita expenditures by state governments. In 1976, for example, Texas spent $547 per capita. That exceeded only the $533 spent by Florida and the $502 spent by Missouri and was well below the national average of $718.

Severance taxes on the production of crude oil and natural gas provide an important source of state revenues in Texas, accounting for a fifth of all state tax collections in fiscal 1977. Thirty-one states collect severance taxes on one or more natural resources, and Texas, as the leading producer of oil and gas, collected two-fifths of all severance tax revenues in the nation.

Severance, or production, taxes are imposed on the value of certain classes of natural resources—such as minerals, fuels, and timber—when they are severed from the earth or water. This type of tax is a convenient means of taxing nonresidents since a large part of the production of natural resources typically is exported to distant markets, where out-of-state consumers must shoulder a considerable part of the cost of the severance taxes.

Many states, however, do not have extractive industries that can provide significant severance tax revenues. Furthermore, even low tax rates on the production of resources, such as timber, can retard the development of an extractive industry and cause it to develop in other states where taxes are lower. But the demand for many commodities is relatively insensitive to prices, and this sets the stage for effective severance tax programs, with much of the cost "exported" to residents outside the state. The principal oil- and gas-producing states of Texas, Louisiana, and Oklahoma, therefore, collect the major share of state severance tax revenues. New Mexico receives substantial severance tax revenues from uranium, coal, copper, and potash mining, as well as oil and gas production; and Kentucky and Minnesota derive large severance tax revenues from coal mining and ore production, respectively.

Because severance tax rates are applied to the value of the oil and gas produced in Texas, any change in market price or quantity of production directly affects the amount of taxes collected. The fourfold increase in energy prices resulting from restrictions in output achieved by the Organization of Petroleum Exporting Countries (OPEC) produced a windfall for the state in increased severance tax revenues. But gains in oil and gas

production taxes are now slowing, and future collections will depend, in part, on Government pricing policies. Price controls have been in effect on some classes of crude oil production since the wage-price freeze in August 1971, while interstate prices of natural gas have been regulated since 1954. However, it was not until after the 1973 Arab oil embargo that a comprehensive set of controls evolved, having the objectives of reducing U.S. dependence on oil imports and restraining the rise of domestic prices.

In the long run, however, severance tax collections will depend on the levels of oil and gas production. With proved reserves declining, the incentive to explore and develop new oil and gas reserves will depend largely on market prices and drilling costs. Thus far, market prices have been high enough to stimulate the development of new wells in known fields. But drilling costs are on the rise, and whether future prices provide the incentives to explore in prospective areas where the risk of failure is much greater remains to be seen.

Severance taxes in Texas

Texas levies severance taxes on the output of four commodities—crude oil, natural gas, sulfur, and cement. However, the revenues from oil and gas are substantially greater than those from sulfur and cement. For example, in the fiscal year ended August 31, 1977, severance tax revenues from oil and gas were $901 million, compared with $8.5 million from sulfur and cement.

The production of crude oil has long been a source of tax revenue for Texas. Four years after the 1901 discovery at Spindletop, the Kennedy Gross Receipts Law was enacted. That law levied a 1-percent tax on the gross value of crude oil production and a 2-percent tax on the gross receipts of pipeline companies and wholesalers. The law also served as a model for other states in taxing the production of their petroleum resources.

The tax rate set by the Kennedy Gross Receipts Law on oil production was amended three times. In 1907 the rate was lowered to 0.5 percent, but it was raised to 1.5 percent in 1919 and to 2.0 percent in 1923. However, the discovery of the giant East Texas field in late 1930 led to a sharp break in oil prices. Production from the East Texas field surged to a third of the state's total output in 1931 and to half in 1933, or to more than a fifth of total U.S. production. Oil prices in Texas, which averaged 99 cents a barrel in 1930, fell as low as 25 cents a barrel in 1933.

The Texas Legislature enacted a new severance tax law on the production of crude oil in 1933, but the tax rate of 2 percent of the market value of crude produced was maintained. The tax rate was subsequently increased in 1936 and 1941, and the present rate of 4.6 percent was established in 1951.

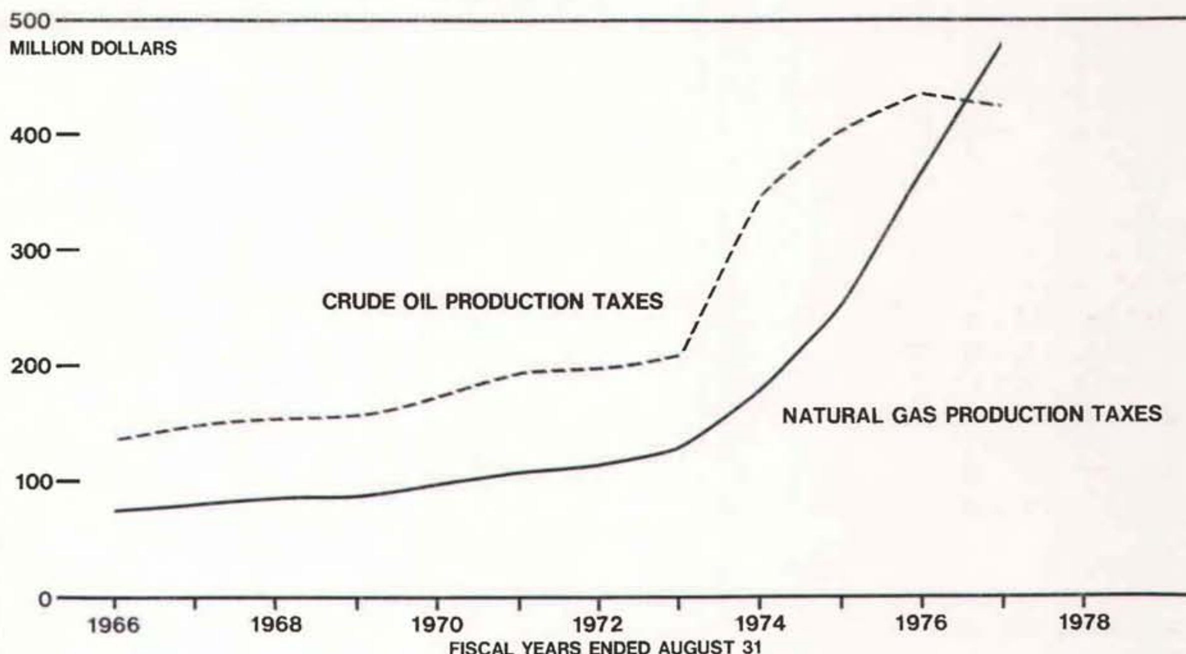
Because natural gas had little or no value in the early development of the petroleum industry in Texas, no production taxes had been imposed on it. But by the early thirties, markets for gas were expanding, and gas production was becoming more important and profitable. The legislature enacted the first production tax on natural gas in 1931 at the rate of 2 percent of the market value of gas produced. Six subsequent changes in the tax rate were made, and the current rate of 7.5 percent was established in 1969.

Severance tax rates have been changed fairly infrequently, usually as part of an overall evaluation of all sources of tax revenues when the state legislature makes significant changes in expenditures. The state is currently running a budget surplus and, therefore, is not likely to boost severance tax rates. However, in the future, if state revenues fall below expenditure levels or if the share of oil and gas production taxes declines, it is quite possible that the legislature would consider increasing severance tax rates.

Tax windfall as energy prices soared

In the late sixties and early seventies, production tax revenues from oil and gas grew at nearly the same rates, although oil revenues were nearly double the gas revenues. Revenues increased dramatically when the OPEC cartel quadrupled "world" oil prices in 1973. For example, from fiscal 1973 to fiscal 1974, Texas taxes collected from crude oil production rose 65 percent to $347 million and gas production taxes rose 39 percent to $173 million. In fiscal 1977, severance taxes from oil and gas production were 170 percent greater than four years earlier.

Oil and gas production taxes also provided a growing share of total state revenues. In fiscal 1973, for example, they ranked as the fourth largest source of revenue and accounted for 7.5 percent of total revenues. The next year they moved ahead of motor fuel taxes but still lagged behind Federal funding and the general sales tax. In fiscal 1977, taxes on oil and gas accounted for 12.2 percent of state revenues. The increase in production tax revenues from oil and gas resulted largely from the sharply higher prices for these commod-



ities and masked the decline in oil and gas production in Texas after 1973.

If the OPEC nations had not boosted world oil prices and severance taxes from oil and gas in Texas had increased at about the trend rate of growth in the late sixties and early seventies, Texas tax collections for fiscal 1974-77 would have been about half the sum actually collected, or about $1.3 billion less. The increase in revenues attributable to the OPEC oil price boost is about the same size as the $1.1 billion increase in the budget surplus during the same four-year period. Hence, the rise in oil and gas prices has put off the need to raise severance taxes or revenues from other sources.

Despite the sharp increase in oil and gas production tax revenues since fiscal 1973, the windfall that accrued would have been substantially greater if domestic price controls had not been imposed on crude oil. The three energy acts since 1973 have restricted the growth of oil and gas production tax revenues, but the effect on gas severance taxes was nominal since sales of natural gas shifted rapidly from the regulated interstate market to the unregulated intrastate market.

The Energy Petroleum Allocation Act, January 1974, adopted the two-tier system of prices for "old" and "new" oil, which placed a ceiling on old oil and left new oil prices unregulated.[1] The Energy Policy and Conservation Act, December 1975,

1. "Old" oil was defined as oil properties that were producing prior to 1973, with the exception of stripper wells producing less than 10 barrels a day.

"New" oil was defined as stripper wells, oil reserves discovered after 1972, and all the production from old properties that exceeded their average monthly output in 1972. That average, called the monthly base production control level, was defined as the volume of output that old properties produced during the corresponding months in 1972.

established a composite, or weighted-average, price for crude oil and effectively put a ceiling on new oil. Finally, the Energy Conservation and Production Act, August 1976, set up a three-tier price structure by deregulating stripper well production and retaining a composite price for lower- and upper-tier oil.

These acts, plus the decline in production of crude oil, caused a leveling off in oil production tax revenues. In fact, oil tax collections declined slightly in fiscal 1977 and, for the first time, fell below collections from the production of gas. While oil tax revenues doubled from fiscal 1973 to fiscal 1977, revenues from natural gas more than tripled as producers redirected sales to the intrastate market, where prices—not subject to controls—rose much faster than on gas distributed interstate.

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Oil severance tax revenues would have been higher if domestic oil prices had not been controlled. Using the average price of new oil in 1974 and 1975 and stripper oil prices in 1976 and 1977 as proxies for free market prices for Texas crude, oil production taxes in 1973-77 would have been about $1 billion greater than actual collections. A similar estimate can be made for natural gas. Assuming the free market value of Texas natural gas would have been at least as high as the average price of intrastate gas in Texas, severance tax revenues would have been about $340 million higher than they were. It appears, therefore, that at least $1.3 billion of severance tax revenues was forgone as a result of price controls.

Prospects for severance taxes

The sharp rise in tax revenues from oil and gas production appears to be over and a return to the slower rates of growth in the 1960's is imminent, given the current tax rates. Oil tax revenues in fiscal 1978 have been unchanged from the comparable period a year ago, even though the price ceilings for upper- and lower-tier oil were raised for the first time since July 1976. And the rate of increase in gas tax revenues has slowed to nearly half the rate in fiscal 1977.

Tax revenues from oil production apparently will be constrained by both the trend of production in Texas and prices. Prospects for any sizable increase in production are, at best, debatable, and prices appear to be stabilized by supplies as well as regulations. Oil industry spokesmen indicate that about 3 million barrels of crude oil are now going unsold daily in the free world, and an additional 6 million barrels a day are not being produced because the market will not absorb them at current prices. These sources estimate it may take three to five years before growth in world demand exerts any significant upward price pressures. This supply situation also constrains OPEC.

While crude prices in Texas average about $5 a barrel less than the landed cost of imported crude oil, it is expected that prices will increase at about the rate of inflation. Under the Energy Conservation and Production Act, the composite price of upper- and lower-tier oil is permitted to rise at the rate of increase of the GNP deflator, up to a maximum of 10 percent per year. Stripper oil prices could increase faster but that is not likely, given the current supply conditions.

The President's proposed special wellhead, or cost equalization, tax on crude oil probably would not have a significant impact on production tax revenues in Texas. Under that program, wellhead taxes would be imposed on existing supplies of old and new oil in amounts equal to the difference between current oil price ceilings and the world price. Such a scheme would significantly raise domestic oil prices. But it would have little effect on the current rate of oil production tax collections in Texas because the production tax would be levied before the wellhead tax is imposed.

An alternative measure to reduce oil imports, should the wellhead tax not be enacted, is an oil import fee. Such a levy would increase the price of imports by $5 to $6 a barrel and leave the current controls on domestic oil prices unchanged. Again, the decrease in consumption due to a higher average price would come at the expense of foreign suppliers, so oil production taxes would be little affected.

The growth in gas production tax revenues is slowing largely because intrastate prices are leveling off. For example, new contract prices for intrastate gas averaged $1.93 per thousand cubic feet (Mcf) last year, while prices on renegotiated or amended contracts were about $2.01. Those averages were down from the high paid for gas but substantially above the interstate ceiling of $1.49.

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Downward pressure on intrastate prices could develop if producers who have held back from negotiating contracts become pressed for cash. If a higher ceiling for interstate gas is not forthcoming soon, those strapped for cash may opt to sell in the intrastate market, and with enough such sales, intrastate prices would drift down.

Deregulation of natural gas prices would quickly step up production tax collections. The Congress is currently debating a bill to extend price controls until December 31, 1984. The bill provides for the extension of price control to the interstate market, and an initial price ceiling of $1.93 per Mcf is proposed for "new" gas.[2] That ceiling would be allowed to rise at the rate of inflation, as measured by the GNP deflator, plus 3.7 percent annually from April 1977 to April 1981 and then at 4.2 percent a year until December 1984. The ceiling for "old" gas would be adjusted annually by the GNP deflator. Production from stripper gas wells, which produce up to 60,000 cubic feet of gas a day and are not associated with any other producing well, would be priced initially at $2.09 per Mcf and allowed to rise at the rate of inflation. Natural gas prices would be deregulated in 1985.

The proposed legislation would slow the growth in gas production tax collections. The sharp rise in collections in recent years reflects increased sales in the unregulated intrastate market at prices higher than the proposed ceiling. Nearly a fifth of the state's total gas production is now being delivered at contract prices of more than $1.93 per Mcf.

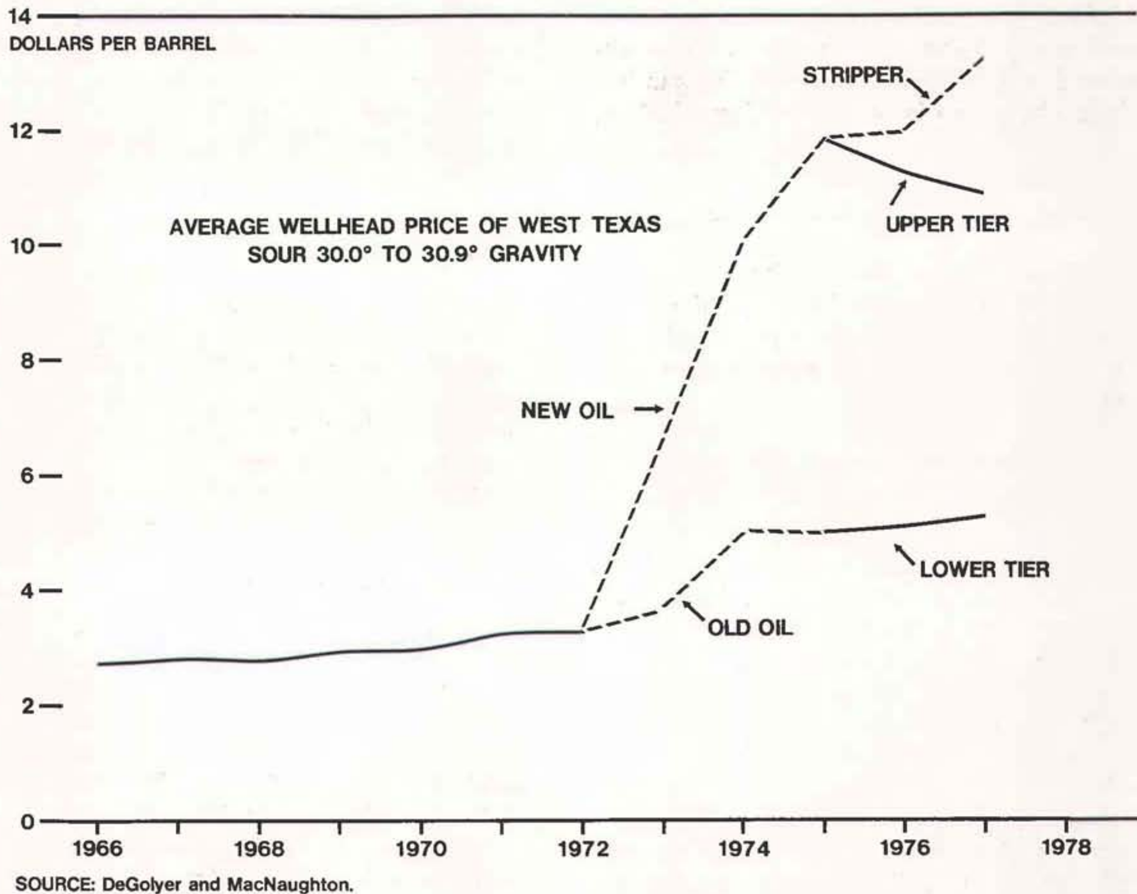
The law would not roll back prices under existing contracts that are above the proposed ceiling, and production taxes on gas sold for more than $1.93 per Mcf would continue at current levels. However, prices in expiring contracts would not generally be allowed to be rolled over at the $1.93 ceiling price. If the price in an expiring gas contract were greater than $1.00 per Mcf in the intrastate market or $0.55 in the interstate market, the renewed contract price would be held at the old contract price and would only be increased at a rate equal to the rise in inflation. Gas in expiring contracts priced less than $1.00 per Mcf in the intrastate market or $0.55 in the interstate market would be subject to ceiling prices of these amounts. Currently, about three-fifths of the gas produced in the state is delivered at prices of $1.00 or less per Mcf in the intrastate market and $0.55 or less in the interstate market.

Historically, most gas contracts were written for a 20-year term, but since the Arab oil embargo, prices in new contracts have been renegotiated annually. Therefore, the mix of expiring contracts in any year is a number of 20-year-old contracts with relatively low prices and a number of short-term contracts with relatively high prices. And because most expiring contracts would not be permitted to be rolled over at current market prices—about $2.00 per Mcf in the intrastate market and $1.49 per Mcf in the interstate market—the increase in gas production taxes would taper off and then rise at the controlled rate.

Future of oil and gas production

Severance tax collections depend in part on the amounts of oil and gas that can be produced. And production depends in part on the price incentives producers have to explore and develop additional reserves of oil and gas. Prior to the quadrupling of oil prices by the OPEC cartel, the incentive to drill was clearly on the decline in Texas, as elsewhere. After peaking in 1956 at 21,519 well completions, drilling activity in the state began a long decline that was reversed only with the 1973 oil boycott. The number of oil and gas wells com-

2. "New" gas is defined as production from a well in a reservoir discovered on or after April 20, 1977, production from a reservoir from which no gas was produced in commercial quantities prior to April 20, 1977, or production from a well that is 2.5 miles or more from the surface location of an oil well.



pleted in the state dropped to a low of 7,728 in 1971, rose modestly to 8,494 in 1973, and then climbed to 14,247 completions last year.

The rise in intrastate gas prices to more than $2.00 per Mcf provided a major stimulus to expand drilling activity, but the boost in interstate gas prices from $0.52 per Mcf to $1.42 in September 1976 added further to drilling operations. Moreover, the unregulated price for new oil until July 1976 and the $10.99-per-barrel ceiling price imposed in July 1976 also encouraged drilling.

Drilling costs, however, have risen sharply. Higher costs have resulted from both the continuing inflation and the increased demand for drilling equipment, supplies, and services. Moreover, with drilling activity now shifting to more difficult and higher-risk areas, costs may rise even faster. Whether drilling activity would rise significantly—given time to expand rigs, supplies, and crews—with current prices of oil and gas is not known.

Drilling costs in the United States rose 11 percent in 1977 and are forecast to rise 12 percent this year, according to industry sources. But some cost increases were substantially greater, depending on location and depth of well. For example, offshore drilling costs rose 16 percent last year to $143 a foot for a 12,500-foot well, while the cost of drilling a 10,000-foot well in East Texas rose 15 percent.

And those sharp increases are outpacing the rise in prices and suggest that the boom in drilling will slow as profit margins are eroded.

In spite of increased drilling, proved reserves and oil and gas production in Texas continue to decline. Proved reserves of crude oil peaked at 14.5 billion barrels at the beginning of 1968 and decreased to 8.5 billion barrels by the beginning of 1978. Oil production rose until 1972, reaching a peak of 1.29 billion barrels, but then dropped to 1.13 billion barrels last year. Proved recoverable reserves of natural gas reached a high of 125.4 trillion cubic feet at the end of 1967 but shrank to 62.2 trillion cubic feet by 1978. Natural gas production expanded until 1972, when output was 8.7 trillion cubic feet, but sagged to 6.8 trillion cubic feet last year.

Although the energy legislation taking shape in the Congress extends price controls on oil and gas to the mideighties, the price ceilings on new reserves would be at higher levels than were proposed initially. And while the proposed ceilings may not be as high as a free market might dictate, they come closer to reflecting the replacement costs of oil and gas resources. Therefore, incentives to drill and produce additional reserves—even in areas where the probability of success is low or that require expensive tertiary methods of production—will likely continue for some time.

For Texas, further increases in drilling activity would slow the decline in oil and gas reserves and extend the life of many fields. The higher ceiling prices will provide the state with a continued high level of production tax revenues. Thus, while the new energy program does not allow the state to reap an additional windfall in severance tax collections, the program does allow further growth in this important source of revenue without increasing severance tax rates.

Joint Policy Established for Examination of Data Centers

A joint policy for the examination of data processing centers that provide services to financial institutions has been established by the Comptroller of the Currency, the Federal Reserve Board, the Federal Home Loan Bank Board, and the Federal Deposit Insurance Corporation.

The new policy, effective May 31, 1978, will eliminate duplication of examinations of data processors by more than one Federal regulator. Data centers operated by one bank or thrift institution will continue to be examined by the regulator responsible for that financial institution. However, if a data center serves more than one class of bank or thrift institution, regulated by different Federal agencies, two alternatives are available. The center will be examined either by a joint examination team, representing more than one of the regulators, or by one of the regulators on behalf of the others. In the latter case, the agencies will be rotated every two years. If the examining agency considers the condition of a data center to be less than satisfactory, the center will be examined jointly until its condition improves to a satisfactory level.

All insured banks or thrift institutions served by an examined data processor will receive the examiner's conclusions, recommendations, and comments, except for those parts of the report dealing with matters of a proprietary or competitive nature.

Fair Housing Advertising and Poster Requirements Revised

Fair housing advertising and poster requirements have been updated by the Federal Reserve Board, the Department of Housing and Urban Development, and other Federal supervisory agencies. The revisions were made to take into account amendments to the Fair Housing Act and the Equal Credit Opportunity Act.

Under the new requirements, banks that advertise loans "for the purpose of purchasing, constructing, improving, repairing, or maintaining a dwelling" must prominently indicate in their advertisements that such loans are made without regard to race, color, religion, sex, or national origin. This requirement can be satisfied in the case of a written advertisement by displaying the symbol with the equal housing lender legend. With respect to an oral advertisement, the requirement is fulfilled by a statement that the bank is an "equal housing lender."

All banks must also display an Equal Housing Lender poster in their lobby. The poster states that it is illegal to deny housing loans or discriminate in the terms of such loans on the basis of race, color, religion, sex, or national origin and that complaints should be sent to the Assistant Secretary for Equal Opportunity, Department of Housing and Urban Development, Washington, D.C. 20410. Copies of the poster were sent to banks in February 1978. If additional posters are needed, state member banks may obtain them from the Federal Reserve; national banks, from the Comptroller of the Currency; and state nonmember banks, from the Federal Deposit Insurance Corporation.

Fed Proposes New Policy on Tax Transactions Between Banks and Their Holding Companies

A new policy concerning tax transactions between banks and their parent holding companies has been adopted by the Comptroller of the Currency and the Federal Deposit Insurance Corporation and has been proposed by the Federal Reserve Board. The policy requires that tax payments by a bank to its parent holding company must approximate the amount of its payments and the time at which they would be made if the bank filed as a separate entity. In addition, the new policy requires that banks incurring a loss for tax purposes should receive an equitable refund from their holding company.

If in the past a bank has transferred to its parent a deferred tax account in excess of the appropriate amount or prior to the appropriate time, these transfers should be either reversed immediately or treated as an interest-paying loan to the bank holding company.

Additional information on the Board's proposal may be obtained from the Holding Company Supervision Department, Federal Reserve Bank of Dallas, (214) 651-6120.

Bank Holding Company Study Completed

The effects of bank holding companies on banking and related nonbanking fields have been a matter of interest and controversy for some years. What are the effects on competition, public benefits, the convenience and needs of communities for banking and related services, the operating performance and efficiency of bank and nonbank subsidiaries of bank holding companies, the safety and soundness of banking, and the concentration of banking resources?

A staff study for the Board of Governors of the Federal Reserve System furnished recently to the Senate Banking Committee provides a comprehensive review and evaluation of existing research on bank holding companies. Releasing the study, G. William Miller, Chairman of the Federal Reserve Board, cautioned that despite the large amount of research that has been done, it is difficult to draw unambiguous conclusions on the impact of bank holding companies.

The principal findings of the staff study, as summarized by the Board, are as follows.

"Operating Policies

"An important consideration in evaluating the performance of bank holding companies as well as interpreting the implications of proposed changes in regulatory and supervisory policies centers on the extent to which BHCs operate their subsidiaries as single integrated entities as opposed to collections of commonly-owned but autonomous companies. The available evidence is limited but suggests that BHCs tend to operate their organizations more as integrated entities than as separate operations. This is reflected in part by the fact that BHCs typically try to exercise control, through organizational structure, over the management philosophy and broad operating policies of both their bank and nonbank subsidiaries. In addition, BHCs generally exercise at least some control over various specific operational areas. However, this seems to be somewhat less so, on average, with bank subsidiaries than with nonbank subsidiaries. In addition, there appears to be more variance among BHCs in the degree to which they integrate their bank subsidiaries relative to their nonbank subsidiaries. Finally, one factor which no doubt limits full integration of any BHC system is the legal restrictions that apply to financial transactions between a bank subsidiary and its bank and nonbank affiliates.

"Performance

"The organizational structure and perceived behavior of BHCs have led many observers to expect that they will have an important effect on the financial and operating performance of their subsidiaries. Because of the relevance of firm performance to several policy areas related to competition and safety and soundness, and because of data availability, BHC performance is the most extensively investigated facet of the BHC movement.

"Evidence from simple univariate analyses as well as more sophisticated analyses has yielded relatively consistent and conclusive results. First, it is clear that multi-BHCs have had a significant effect on the asset structure of acquired banks. Most notably, BHC banks hold less cash and U.S. government securities, more state and municipal bonds and more loans per dollar of assets than independent banks. Second, in addition to holding what is generally regarded to be a riskier portfolio, the evidence indicates that multi-BHC banks exhibit lower capital-to-asset ratios than comparable independent banks. Third, BHC banks exhibit significantly higher earnings *and* expenses subsequent to affiliation

while their profitability remains relatively unchanged. Finally, BHC banks do not grow any faster than other banks. In short, BHC banks exhibit riskier portfolios and more leveraged capital positions than similar unaffiliated banks, but their profitability and growth are no different.

"As with many of the issues raised by BHCs, evidence on the impact of BHCs on performance of nonbank affiliates is extremely limited. Therefore, any conclusions must be regarded as tentative. In fact, only two of the 17 activities authorized have been studied. In mortgage banking, the evidence from the one available study suggests that BHC affiliates are not as profitable, do not grow faster and are more highly leveraged than independents. With respect to the consumer finance industry, the two studies show that BHC affiliates are less profitable, more highly leveraged, incur marginally higher interest expenses on borrowed funds and grow faster than independent finance companies. In sum, the only consistent evidence from the two nonbank activities that have been subjected to empirical investigation is that the nonbank affiliates of BHCs tend to be less profitable and more highly leveraged than their independent counterparts.

"Efficiency

"In evaluating proposed acquisitions by BHCs, the Board is required to consider the effect of the proposal on efficiency. . . . Since gains in efficiency may be regarded as a public benefit, possible efficiency gains must be weighed against possible adverse competitive and financial effects of acquisitions.

"The large size of BHC organizations has led many observers to expect that affiliation with a BHC will lead to economies of scale as well as economies of organization. The available empirical work deals almost entirely with bank affiliates and suggests that a bank can achieve some economies of scale by affiliating with a bank holding company. However, it will also incur additional expenses. Small affiliated banks—especially unit banks—may not be able to achieve levels of output sufficient to offset these increased expenses until they reach a sufficient size. Thus, as affiliated banks grow (over $30 to $40 million), the economies of affiliation enable holding company subsidiary banks to operate as, or more, efficiently than independent banks. These same studies also suggest that these gains in efficiency taper off as the affiliated banks become large.

"Less sophisticated 'ratio' studies imply that affiliated banks have higher 'other' operating expense ratios than unaffiliated banks. This is probably due to management fees and other expenses charged by the parent BHC as a means of transferring funds within the organization, and hence, should not necessarily be interpreted as evidence of organizational diseconomies or inefficiencies.

"There is only fragmentary evidence pertaining to efficiency and the existence of scale economies in the nonbanking activities of bank holding companies. The one available study indicated that affiliated finance companies did not have significantly different operating expenses from unaffiliated companies.

"Safety and Soundness

"The past five years have seen increased concern about the stability of the banking system. Particular interest has been focused on the impact of BHCs and expansion in the nonbanking areas on bank safety and soundness. There are four avenues through which the BHC form of organization may be expected to affect the risk exposure of banks. These include (1) expansion of banking type activities through nonbank affiliates, (2) expansion into other bank activities, (3) multibank expansion and (4) parent company leveraging.

"With respect to banking activities, multibank expansion has resulted in increased risk exposure through greater leveraging and riskier portfolios for subsidiary banks than for independent banks. Whether this is offset entirely or ameliorated by the attendant geographic diversification is not known. With respect to nonbank affiliates, the little available evidence indicates that such affiliates are more highly leveraged than their independent counterparts. At the same time, there is also some weak evidence of product-line diversification benefits resulting from nonbank expansion which would tend to reduce risk. Finally, available evidence suggests that parent holding companies have leveraged significantly in recent years. In many cases, this leveraging has provided equity funding for BHC banks; however, even with such equity injections, BHC banks as a group still tend to be more highly leveraged than their independent counterparts.

"Although BHCs may maintain a riskier financial position in their banking and nonbank affiliates than do independent banks or comparable nonbank firms, the diversified structure and legal organiza-

tion of BHCs makes it difficult to assess the net effect of this increased risk exposure and whether it has actually reduced safety and soundness in the banking system. Moreover, it remains to be seen whether this apparent risk-taking is greater than is socially desirable.

"Competition

"The Federal Reserve Board is required to consider the possible adverse effects of proposed bank and nonbank acquisitions in deciding whether or not they should be approved. This concern for the competitive effects of BHC acquisitions arises from the recognition that the degree and intensity of competition in a market will determine economic performance of the market in terms of the prices paid and profits realized. The empirical studies relevant to assessing the impact of BHCs on competition have not examined the impacts that BHCs have had on market prices, price-cost margins or profits. Rather they have focused on the effects of BHCs on market structure and made inferences about market performance from changes in market structure. That is, if BHCs result in an increase in the number of independent firms operating in a market, for example, the inference is that this is a positive structural effect that must have a procompetitive effect on market performance.

"In general, because of the apparent aggressiveness of BHCs and because the organizational form provides a convenient mechanism to circumvent restrictive branching laws and other barriers to entry, it has been anticipated that BHCs would have a procompetitive effect on market structure. Certainly *de novo* expansion, to the extent that it results in new entry into markets, must be procompetitive. Bank holding companies have expanded *de novo*, but the majority of this expansion has been within markets in which the organization already operated. Studies of the effects of BHCs on banking market concentration—an important dimension of bank market structure—have yielded mixed results. The bulk of the work suggests that BHC activity has had little systematic or significant effects on banking market concentration and, hence, little pro or anticompetitive effects.

"Conclusions regarding the competitive effects of BHCs in nonbanking activities must be regarded as highly tentative, because there have been so few studies and these are subject to serious shortcomings. What evidence exists suggests that in consumer finance, BHCs may have had a procompetitive effect since the relatively rapid growth of BHC affiliates could be due to procompetitive pricing policies. In mortgage banking, however, BHC affiliates are less profitable and more highly leveraged than independents. This provides little indication of either a pro or anticompetitive effect on pricing behavior or performance. In short, available evidence suggests that BHCs have little, if any, effect on competition in banking or nonbanking markets.

"Concentration of Banking and Financial Resources

"Throughout the history of legislation regulating BHCs, the Congress expressed concern with various dimensions of concentration—market concentration and aggregate or undue concentration. This reflects a concern about implications of market concentration for competition and the possible implications of state and national levels of concentration for basic segments of the economic system as well as the socio-political systems.

"Bank holding companies have not significantly increased their control over aggregate financial resources in the economy as a whole; nonbanking resources still account for less than 4 percent of bank holding company resources. BHCs now control about 71 percent of domestic bank deposits, but only about 8 percent of these deposits are outside lead banks. Thus, most of the recent increase in BHCs' share of domestic deposits is due to conversion by existing banks to the BHC form of organization and not to acquisitions by existing BHCs.

"Bank holding companies also have not significantly increased concentration in commercial banking at the national, state or local levels. Nationally, concentration in banking has declined gradually, but steadily, since 1934. It has been estimated that between 1968 and 1973, concentration is at most 2-3 percentage points above what it might have been if bank holding companies had not existed. Similarly, at the statewide level, concentration has declined on average between 1960 and 1976 (although it increased slightly since 1970) or at best remained stable, depending upon the measures used. The greatest declines, however, have been in the most and least concentrated states. Large increases in concentration directly attributable to bank holding company acquisitions have been limited to the low and moderately concentrated states. Locally, no significant, systematic increases in concentration have been attributed to bank holding

companies. In general, local markets have tended to exhibit more competitive structures.

"Within the more significant nonbanking industries—mortgage banking, consumer finance companies, leasing and factoring—in which bank holding companies have been permitted to expand, the picture is more mixed. Bank holding companies have not been a significant force in the leasing industry. Significant consolidation and structural change have taken place among consumer finance companies, and a number of the top 100 firms have been acquired by financial and nonfinancial companies and banks; but bank holding companies have not played an important role in this process. Bank holding companies are important owners of mortgage banking firms and now account for 42 of the top 100 mortgage services, but very few have been acquired since the early 70s. Factoring is the one industry that now is most clearly dominated by banks and bank holding companies which now have about 56 percent of the factoring business and 17 of the top 20 firms. Most of these firms have been acquired since 1968.

"Convenience and Needs and Public Benefits

"The Board is required to consider the convenience and needs of communities in evaluating proposed BHC bank acquisitions.... Partially because of the difficulty of conceptualizing and measuring public benefits and convenience and needs, there have been very few studies on the subject. Those few that have been conducted reveal several points. First, in considering BHC applications, the Board focuses on several public interest considerations including the ability to obtain additional capital, provide additional or new services, increase competition, and improve efficiency and managerial resources. It is concluded, however, that if a serious anticompetitive effect exists, convenience and needs factors seldom, if ever have tipped the scale in favor of approval. Second, the chief public benefit resulting from BHC activity has been the increased availability of credit to the local community (through loans and municipal finance). Counterbalancing this increased credit availability, however, have been greater leveraging and some indication of poorer operating performance in nonbank markets. Third, the one study of post acquisition effects found that BHCs have tended to fulfill most, but not all, of the public benefit actions they have proposed—most notably with respect to trust services and data processing services, recruitment, and loan expansion.

"Conclusions and Directions for Future Work

"The evidence suggests the principal economic effect of the BHC movement to date has been to facilitate increased leverage and the acquisition of more loans and other risky assets, mainly for the bank subsidiaries. To the casual observer, this may suggest a weakening of the stability of the financial system. However, there are a number of factors that must be considered. First, it is not clear that increased risk taking by individual BHC subsidiaries implies that the overall organization has become more risky. This would be true only if there were no benefits from organizational and geographical diversification. Unfortunately, there is little evidence on the extent to which BHCs have resulted in reduced risk through diversification. Second, from a supervisory and public policy point of view, increased risk taking in the system as a whole should only be of concern if it is assumed that the financial system has already achieved the socially desirable level of risk. If the opposite is the case, then the increased risk that might be attributable to BHCs would clearly be in the public interest. Third, the increase in BHC leverage has enabled the organizations to expand lending, particularly to consumers and state and local governments. While such lending may be riskier than holding liquid assets or U.S. government securities, it clearly represents what might be viewed as a potentially socially desirable use of financial resources. An overall assessment, then, of the effects of increased leverage attributable to BHCs requires a balancing of what might, or might not, be increased organizational and/or system risk against the benefits that result from increased availability of funds.

"Few other aspects of BHC operations yield as consistent results as the impacts on leverage. To the extent that BHCs have resulted in increased competition, the evidence suggests it is through *de novo* expansion or foothold entry rather than by acquisition of significant competitors. The common argument, however, is that *de novo* expansion is costly and not economical. Moreover, there may be long delays between the time an institution expands in this way, until it becomes an effective competitor. Again, however, next to nothing is known about the alternative costs of entry and foothold expansion.

"Perhaps the least is known to date about BHC nonbanking activities. Only two activities have received attention at all in the published studies—mortgage banking and consumer finance—and here

the evidence suggests little about the long run impacts of BHCs. Not only are the studies few in number, they also suffer from the weakness that they cover a short time span at the early phase of BHC involvement in the activity. Equally important—and this applies to most of the work on BHCs in general—much of the evidence on the impacts of BHCs was generated during the period in which the economy experienced the greatest decline in economic activity since the Great Depression. Thus, it is not clear whether the results can be generalized.

"In terms of directions for future work that would be relevant to formulation of public policy, there are several areas that seem critical. The first relates to the operational and organizational characteristics of a BHC and the extent to which it affects risk taking. Included should be work on the relationship between diversification and risk as well as (1) the extent to which risk may be transferred from one subsidiary to another in a BHC and (2) the role of capitalization in a BHC and its effects on the riskiness of the organization. Second, additional attention is needed on the competitive effects of BHC affiliation. Existing work has been directed toward the effects on structure and not the implications for behavior, rivalry, and price-cost margins. Third, the work on efficiency and performance needs to be expanded with particular emphasis on the effects of alternative means of transferring funds within a system on measured efficiency. Fourth, there has been no analysis of the effects of BHCs on fund flows and allocation of resources."

Texas Leads in Number of New Banks in 1977

Texas accounted for 13 percent of all new-bank openings in the United States in 1977. According to figures released by the Comptroller of the Currency, 145 new banks began operations in 1977. Twenty of these—the highest number in any one state—were in Texas. Other states with a large number of new-bank openings were California (15), Illinois (13), and Florida (10).

New-bank growth in Texas is again strong in 1978. As of June 1, eight new banks had opened in Texas this year, one less than at the same time last year.

Of the 28 new banks opened in Texas from January 1, 1977, to June 1, 1978, 15 have national charters and, thus, must be members of the Federal Reserve System. This brings the total number of member banks in the Eleventh District to 695 as of May 31, 1978.

Art Exhibited at the Dallas Fed

"A Chimera," etching by John Taylor Arms, 1948
(Courtesy of the Cleveland Museum of Art)

An exhibit of etchings, entitled "Between Past and Present: French, English, and American Etching 1850-1950," will be shown at the Federal Reserve Bank of Dallas from July 24 to August 18. The exhibit will be open to the public, free of charge, from 9:00 a.m. to 3:00 p.m., Monday through Friday. The exhibit is on loan from the Cleveland Museum of Art, which assembled the etchings from its own and several private collections.

The 49 prints in the exhibit are divided into six categories: country views, river views, cityscapes, romantic monuments, picturesque views, and city streets. Two basic themes are evident: the relationship between country and city and the juncture of past and present.

The exhibit originated at the Federal Reserve Bank of Cleveland and has traveled to Federal Reserve banks and branches in Cincinnati, Pittsburgh, Philadelphia, and Atlanta and to the Board of Governors in Washington, D.C. It is part of a System effort to make its facilities available for community cultural activities.

Federal Reserve Regulations to Be Streamlined

All Federal Reserve Board regulations and related interpretations and rules are being critically reviewed for the purpose of modernizing and improving them. The review, the first of its kind since the Federal Reserve System began operations in 1914, is being called "Augeas" after the mythical Greek king whose stables were cleaned by Hercules after 30 years of neglect.

The review will be in two parts. First, the Board's 26 regulations will be studied for possible improvements in overall format and structure. This will be followed by a detailed study of the purpose and content of each regulation. The regulations will be studied to determine whether they are required by law, what their costs and benefits are, whether they continue to be in the public interest, whether statutes underlying the regulations need revision, and whether there are more desirable nonregulatory alternatives. After these factors are considered thoroughly, each regulation will be redrafted, with changes ranging from simplification of the language to elimination of parts of the regulation not required by law. The Board may also make recommendations to the Congress for statutory changes.

Each Reserve Bank has been assigned regulations to review. The Federal Reserve Bank of Dallas will review Regulation L, which restricts the relationships a director, officer, or employee of a member bank can have with other banking institutions; and Regulation O, which prohibits member banks from extending credit to their own executive officers, except as specified.

The review and any regulatory revisions or recommendations to the Congress for legislative changes are expected to be completed by the end of 1979.

TT&L Program Postponed

The Treasury's new Tax and Loan Investment Program is being postponed until appropriations are obtained from Congress. The program was originally planned to begin July 6, 1978.

Under the new program, banks and other financial institutions that hold Government tax and loan deposits will be obligated, for the first time, to transfer the funds to Federal Reserve banks in one business day or pay interest on them. The Treasury Department will also begin paying for certain services the depositaries provide that currently are not compensable.

Commercial Loan Charge-offs

The Robert Morris Associates, an organization of bank credit officials, has recently published a study of 1977 loan charge-offs. The data are not necessarily representative of all banks since participation was voluntary. However, the publication includes reports from 751 banks that were estimated to have about 54 percent of all loans outstanding in U.S. commercial banks during 1977. All regions and all size banks were represented.

Gross loan charge-offs at these banks in 1977 averaged 0.64 percent of their average loan portfolio. For each $5 charged off, about $1 was recovered. Net charge-offs, therefore, averaged almost exactly one-half of 1 percent of average loan portfolio.

By region, net charge-offs averaged highest in the Atlanta Federal Reserve District (0.82 percent) and lowest in the Dallas District (0.28 percent).

By bank size, net loan charge-offs were highest for the smallest size group of banks, under $50 million in total assets, (0.74 percent), and lowest for banks with $100 million to $200 million in total assets (0.30 percent). Excepting the smallest size group, net charge-offs tended to vary directly with asset size, the highest percentage net charge-off being reported for banks over $5 billion in total assets and declining with succeeding smaller size groups. However, size was no guarantee that loan charge-offs would be high or low for individual banks. The dispersion was great within every size group.

By type of loan, net charge-offs as a percentage of loan portfolio were highest on loans to financial institutions (0.98 percent) and lowest on securities loans (0.02 percent). In this tabulation the "financial institutions" category included real estate investment trusts. Following in descending order after loans to financial institutions were loans to individuals, farming, commercial and industrial firms, real estate, "all other," and securities.

The greatest amount of dollars charged off was for loans to real estate investment trusts, with charge-offs on loans to real estate subdividers and developers a strong second. In terms of the incidence of charge-offs, individuals were cited most often, but this category of loans was well down the list in terms of total dollars charged off. In the Dallas Federal Reserve District (56 banks reporting), charge-offs in descending order, both in total dollars and in number of times cited, were: individuals, single-family housing construction, real estate subdividers and developers, real estate investment trusts, holding companies, and industrial building construction.

The data presented on loan charge-offs by size of bank and type of loan for each Federal Reserve District should not be used to generalize about all banks in each District since the number of banks in each cell was necessarily small. With this reservation in mind, for the Dallas District the total dollars charged off was highest or second highest for loans to individuals or to commercial and industrial firms for each size group of banks—the only exception being banks in the group with $1 billion to $5 billion in assets, where real estate loans ranked second in total dollars charged off. In three of the six size groups of banks, real estate loans ranked third in total dollars charged off.

The report also includes limited data on experience with international loans and a forecast by the participating banks that the greatest incidence of loan charge-offs in 1978 will occur for real estate subdividers and developers, single-family housing construction, and eating places. Real estate investment trusts hold fourth position in this list.

APR Computer Program Available to Member Banks

A FORTRAN computer program used by the Federal Reserve System to calculate the actual annual percentage rate for consumer instalment loans is now available to member banks, free of charge. The program, primarily useful for checking the accuracy of a bank's own APR calculations, will be released in the form of a source card deck. Procedures for use and sample test cases will also be provided. Member banks wanting the program should contact, by letter, the Consumer Affairs Section of the Federal Reserve Bank of Dallas.

Consumer Credit Recordkeeping Extended

An amendment to Regulation Z requiring banks, savings and loan associations, and credit unions to retain all records of consumer credit transactions dating back to July 1, 1969, has been adopted by the Federal Reserve Board. Previously, Regulation Z required creditors to keep the records for two years from the date the loan was made.

The recordkeeping extension, effective May 19, 1978, is a temporary move until uniform rules for enforcement of the Truth in Lending Act are agreed on by the Federal financial regulatory agencies. One policy under consideration involves reimbursement to borrowers for certain violations that may have occurred more than two years ago. Consumer groups were concerned that evidence of such violations could be destroyed before the new enforcement guidelines were implemented. To eliminate this possibility, the Board has extended indefinitely the length of time creditors must retain consumer credit records until the regulators adopt a uniform enforcement policy and one examination is completed under the new guidelines.

Officers' and Employees' Salary Surveys Offered Again in 1978

The Federal Reserve Bank of Dallas is again conducting an Officers' and Employees' Salary Survey program for member banks in the Eleventh District. To participate, bankers should complete the questionnaire that was recently mailed to all member banks in the District. If your bank did not receive the questionnaire or if you have any questions, please call the Bank and Public Information Department, (214) 651-6261.

Approximately 350 banks participated in the surveys last year. In return, they received reports containing extensive salary and personnel data for 31 official positions and 28 employee positions. Data are given on the average, minimum, and maximum salary of each position, along with information on seniority, bonuses, retirement, insurance, and other incentives. Comparisons are provided on the basis of bank size and geographic location.

The Federal Reserve Bank of Dallas first offered the Officers' Salary Survey program in 1972 and expanded the program a year later to include an Employees' Salary Survey.

Computation of APR for Graduated-Payment Mortgages to Be Simplified

In order to simplify the computation of annual percentage rates for graduated-payment mortgages, the Federal Reserve Board has proposed an amendment to Regulation Z. Since graduated-payment mortgages, by their very nature, involve unequal instalments, the computation of their annual percentage rate is difficult. To facilitate computation, the proposed amendment would allow annual percentage rate computation tables prepared by the Federal Housing Administration to be used when homes are bought on a graduated-payment mortgage plan.

Graduated-payment mortgages, which involve one payment period that is different from others, have been developed by the FHA to help young people, and others, to buy homes. Under these mortgages, payments increase annually during the first five or ten years of the mortgage.

“Fed Quotes”

Brief Excerpts from Recent Federal Reserve Speeches, Statements, Publications, Etc.

Restraining inflation

"In our present circumstances, . . . it is unlikely that macroeconomic policies alone can achieve the low unemployment goals of the Humphrey-Hawkins bill without running the grave risk of substantially exacerbating the inflation problem."

"One potential problem inherent in the planning for general economic policies designed to control both unemployment and inflation is that trends in employment tend to respond more quickly to changes in policy, including monetary policy, than do trends in prices. . . . Because of this long tail on inflation, public policies are in danger of giving insufficient weight to potential inflationary pressures unless they focus on a plannng horizon that looks beyond the next year or two."

"While the current versions of the Humphrey-Hawkins bill take more account than earlier versions of the threat that inflation poses to our economic health, they still do not acknowledge adequately the crucial need to reduce inflation, both as an integrated element in the process of achieving full employment and as a necessary condition for effective public and private planning. There is a real risk that the Humphrey-Hawkins bill, if enacted with the present lopsided emphasis, will accord by law a back seat to the need for more effective control over inflation. It seems paradoxical that this might take place at precisely the time when inflationary pressures are coming to represent the major threat to the stability of our economic process."

J. Charles Partee, Member, Board of
Governors of the Federal Reserve System
(Statement before the Committee on Banking,
Housing and Urban Affairs, U.S. Senate,
May 9, 1978)

Too much regulation

"Your business of banking is an excellent example of the consequences that we are experiencing from excessive regulation. I think that the purpose of your industry should be to provide a safe, convenient place to store our savings. It should furnish a cheap, fast means of effecting transactions and it should provide a system whereby the savings of some of us can be used to create more goods and services for all of us."

"The vast majority of banks and bankers are responsible, capable and honest people who are equally able and willing to serve the public interest as well as their own. And the public interest would be best served by removing the shackles of regulation and restraint and giving them the freedom to strive toward doing so."

Philip C. Jackson, Jr., Member, Board of
Governors of the Federal Reserve System
(Remarks before the Alabama Bankers
Association, Mobile, Alabama, May 11, 1978)

Concentration in banking

"At the national level between 1968 and mid-1977, the 10 largest banking organizations' share of domestic deposits declined from 20.4 per cent to 18.3 per cent and the top 25's share dropped from 31.9 per cent to 28.0 per cent. The 100 largest organizations' share declined from 49.7 per cent to 45.0 per cent over this period. A similar pattern is found at the statewide level. . . . Our review of over 400 local markets, including 213 SMSAs, between 1966 and 1975, indicates that the majority tended to become less concentrated and to exhibit a more competitive structure irrespective of the measures used. . . . These figures tend to overstate concentration since they do not reflect the rapid growth of bank type activities at savings and loans, mutual savings banks and credit unions."

"The registered bank holding company share of *domestic* U.S. deposits increased from 16 per cent in 1970 to 70.8 per cent in 1977 but about two-thirds of this increase resulted from the inclusion of over 1,100 one bank holding companies under the umbrella of the Act in 1971. This includes 16 of the Nation's 25 largest banks. Also, it is important to note that while bank holding companies account for 70.8 per cent of domestic bank deposits, all but about 8 per cent of these deposits are in the lead banks of holding companies. Thus, expansion of bank holding companies' share of deposits has been due principally to conversion in the legal status of existing banking organizations to the holding company form and not to acquisitions of existing banks by multibank holding companies."

Philip E. Coldwell, Member, Board of
Governors of the Federal Reserve System
(Statement before the Committee on Banking,
Housing and Urban Affairs, U.S. Senate,
March 7, 1978)

Borrowing against equity in homes

"Household borrowing against equity in existing homes has accounted for nearly half of total home mortgage debt formation during the past 2 years, about double the proportion during the previous 5 years. . . . Significant portions of the funds raised . . . have served to bolster personal consumption expenditures . . . have supported capital expenditures, substituted for other forms of household debt, or contributed to acquisitions of financial assets."

David F. Seiders
"Mortgage Borrowing Against Equity in
Existing Homes: Measurement, Generation,
and Implications for Economic Activity"
(*Staff Economic Studies*, Board of Governors
of the Federal Reserve System, May 1978)

Loan classifications meaningful

"Examiners were successful in categorizing bank loans according to their relative risks of default. Among the sample banks in the study, unclassified loans, substandard loans, doubtful loans, and loss loans had average charge-off rates of .14 percent, 9.61 percent, 58.11 percent, and 94.75 percent, respectively, when these loans were traced by their dollar amounts. Thus, doubtful and loss classifications generally conform to their expected loss patterns. Substandard loans also follow the examiners' expectations of 'loans involving more than a normal risk.' However, the loss experience for substandard loans indicates that a large percent of such loans will experience no further deterioration.

"The study also found that the loan classification procedure was successful in identifying a major portion of loan charge-offs and over 85 percent of the larger loan losses at the sample banks. Thus, a bank's pool of classified loans represents the main source of future loan problems. Also, since classified loans in this study represented an average of 2 to 3 percent of all loans, the examination process appears to be reasonably efficient in separating problem loans from nonproblem loans."

Kenneth Spong and Thomas Hoenig
"Bank Examiner Classifications and Loan Risk" (Unpublished paper, Federal Reserve Bank of Kansas City, February 1978)

More on banking regulation and competition

"Banks, like all other business organizations in our country, should have the freedom to open up shop where the needs are greatest and the opportunities strongest. Not only should we allow state-wide branching by any bank organized within a state but we should also authorize interstate full-service operations for any bank authorized to do business in our country."

"I find it hard to understand how the House of Representatives could overwhelmingly pass, as it did, a bill to give foreign banks the authority to branch across state lines. It seems to me inconsistent to have these foreign visitors enjoy privileges that we don't authorize for ourselves. Certainly we should have one rule apply to all who are striving to perform the same public function."

Philip C. Jackson, Jr., Member, Board of Governors of the Federal Reserve System (Remarks before the Alabama Bankers Association, Mobile, Alabama, May 11, 1978)