The 1970 Amendments to the Bank Holding Company Act: Opportunities to Diversify

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This luncheon always provides a valuable opportunity to meet early in the year and to exchange views on the problems and prospects facing us. My associates and I recognize that we gain a good deal from both the informal discussions and the formal presentations that are an integral part of these midwinter meetings. Today I propose to share with you some of my thinking about the recent bank holding company legislation in the hope that it may be helpful to your own consideration. I shall also say a few words about our present, far from satisfactory economic situation.

On the last day of the old year, President Nixon signed into law the bill amending the Bank Holding Company Act of 1956 to extend its coverage to one-bank holding companies. The new amendments, the result of almost two years of intensive Congressional review and debate, will surely have a profound impact on the structure of the nation's banking and financial markets. In my view, the law may constitute the most significant banking legislation since the 1930's.

As you know, the 1956 act excluded one-bank holding companies from Federal regulation. This exclusion became a source of public concern in the late sixties, when many major commercial banks formed one-bank holding companies. Free of Federal regulation, some one-bank holding companies acquired or established nonbank subsidiaries in order to engage in a wide variety of activities, some of which were not permitted to banks directly. In addition, a few important industrial conglomerates acquired a single commercial bank, thus mixing banking and commerce—a mixture prohibited by the 1956 act to companies holding more than one bank.

Regulated multibank holding companies, by the way, control banks with about one sixth of the nation's commercial bank deposits, while one-bank holding companies control banks with almost one third of these deposits. This concentration of deposits under the control of companies not themselves subject to regulation would alone have provided sufficient reason for the legislation. However, an even more important reason was the prospect that the traditional separation of banking and commerce might be ended. Thus, the rapid development of the one-bank holding company movement raised not only issues of bank safety and competition, but also the issue of excessive economic power—the possibility that one-bank holding companies might become nuclei of industrial-financial conglomerates which could dominate economic life in the United States. This concern was expressed by President Nixon when he endorsed the proposed one-bank holding company legislation in March 1969:

> Left unchecked, the trend toward the combining of banking and business could lead to the formation of a relatively small number of power centers dominating the American economy. This must not be permitted to happen; it would be bad for banking, bad for business, and bad for borrowers and consumers.

In the several years preceding enactment of the legislation, there was little in the pattern of acquisitions by one-bank holding companies to suggest that they might be seeking such domination. The bank-centered one-bank holding companies have appeared to be more interested in offering diversified financial services. The banks owned by large commercial and industrial firms have generally

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Note: This address was delivered before the forty-third annual midwinter meeting of the New York State Bankers Association in New York City on January 25, 1971. Mr. Hayes wishes to express his indebtedness for valuable assistance in its preparation to Leonard Lapidus, Assistant Vice President, and Ralph H. Gelder, Manager, Banking Studies Department.

represented a small fraction of these firms' total corporate assets. In any event, the 1970 amendments ended any threat of eroding the barriers separating banks from industry. Indeed, a principal result of the legislation—and one obscured by controversy over other provisions—is to reaffirm the principle that banking and commerce ought to be kept separate.

The 1970 amendments, therefore, bring all bank holding companies under the supervision of the Federal Reserve Board and eliminate loopholes by which a group might be free of Federal Reserve regulation while maintaining effective control of one or more banks. For example, the exemption in the 1956 act that permitted the effective control of chains of banks through partnership arrangements has been eliminated. A bank may also become subject to regulation as a bank holding company if it acquires in a trust capacity controlling shares of another bank and has sole discretionary authority to vote these shares. This provision could pose unusual problems for bank managements.

The Congress did not see fit to provide to existing one-bank holding companies an ironclad exemption allowing them to retain any previously acquired or established nonbank subsidiaries. True, bank holding companies which come under regulation for the first time may continue to engage in nonbank activities which would otherwise be prohibited, provided they have been continuously engaged in them since June 30, 1968. But the Board has the power to terminate a company's authority to engage in such an activity if it finds such action is necessary to prevent undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. The Board is required to make this determination by the year-end 1972 for those newly regulated companies with banking assets exceeding $60 million. The Board also has discretion to take similar action with respect to the other newly regulated holding companies whose banks have assets of $60 million or less, if it believes the so-called "grandfather" exemption is not justified.

While I have spoken up to now only of the restrictive provisions of the legislation, the amendments should also resolve the uncertainties that have hampered banking organizations in planning expansion and do offer new opportunities to regulated holding companies to expand into fields of business related to banking. Indeed, the most controversial and bitterly contested provision of the new law centers on the standards established for Federal Reserve Board determination of those nonbanking activities which would be permitted to bank holding companies. The most critical of these standards are contained in Section 4(c)(8) of the act. I would like to discuss this section of the legislation with you today—for it is the interpretation of its provisions that will determine just how much diversification bank holding companies will be permitted, in terms both of the services they can offer and of the extent to which they can expand geographically.

Under the standards provided in this section the Board must decide if an activity is "so closely related to banking or managing or controlling banks as to be a proper incident thereto". In determining whether a particular activity is a proper incident to banking or managing or controlling banks, the Board is also required to consider whether the performance of a particular activity by a proposed affiliate "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices". In essence, then, the Board must now base its Section 4(c)(8) decisions primarily on two determinations—roughly stated, whether a proposed activity is "closely related" to banking and whether its performance by a banking organization would yield net public benefits.

The language of Section 4(c)(8) dealing with the "closely related" issue represents the key compromise reached by the House-Senate Conference Committee. You will remember that the House of Representatives in its bill took a very restrictive approach in defining permissible activities; the House proposal included the so-called "laundry list" of prohibited activities—a list containing activities such as insurance, travel services, leasing, and mutual funds. The Senate, on the other hand, rejecting the laundry list, supported a proposal suggested by the Board of Governors that would permit bank holding companies to have subsidiaries engaging in activities "functionally related" to banking, leaving the determination of the specific types of permissible activities to the best judgment of the Federal Reserve Board.

The language of the new section is a middle ground between the widely separated views of the House and Senate versions. It is probably fair to say that the legislative history fails to fix clearly the exact location within this middle ground that would indeed represent the "intent of Congress". Consequently, I would expect that the question of what is "closely related" to banking will for practical purposes be decided first by the Board and ultimately by the courts. Court review and determination is likely to occur not only pursuant to appeals by applicants but also because the new law contains a provision which grants to competitors of bank affiliates a clear right of standing before the Board and the courts to challenge applications filed under the act. To be sure, the Congress —if it is not pleased with the decisions of the Board and the courts—might undertake to amend the act again.

Appreciating these difficulties and the legal issues involved, I would still like to tell you what we in the New York Reserve Bank hope this legislation will permit the Federal Reserve System to do. Last May, the Federal Reserve Board through Chairman Burns expressed support for the Senate proposal. At that time, in his testimony before the Senate Banking and Currency Committee, he cited a number of activities that in the opinion of the Board would likely result in public benefit if conducted by bank holding company subsidiaries. He also indicated at that time that granting the Board authority to specify permissible activities by regulation or order would provide flexibility to adjust the list as circumstances change.

When the legislation was before the Conference Committee late last year, Chairman Burns, in reply to a letter from Congressman Patman, addressed himself again to the issues raised in Section 4(c)(8). While continuing to express support for the Senate proposal that permissible activities be "functionally related" to banking, he nonetheless offered insight into the Board's view of the "closely related" compromise wording.

He indicated that the objectives of the Board were to allow bank holding company systems to offer the kinds of bank-related services that they were likely to be able to perform conveniently and efficiently and under conditions that would enliven competition. While these results might be reached by interpretation of the proposed compromise language offered by Congressman Patman, the Board preferred certain changes in the proposed language. One of the most significant changes requested by the Board was to delete from the phrase "so closely related to the business of banking or of managing or controlling banks" the words "the business of", so that the phrase would read "closely related to banking or managing or controlling banks". The deletion of these three words—which might appear to be of small consequence—was significant because of the administrative history of the 1956 act. In the course of administering that act, the Board had interpreted the "business of banking" wording as requiring a "direct and significant connection" between the activities of the proposed subsidiary and those of the subsidiary banks of the holding company. This interpretation had the effect of limiting a bank holding company to those nonbank subsidiaries which serviced or supported the activities of the bank affiliate.

It was the Board's view last November, however, that it would not be "desirable to unduly restrict entry by nonbank subsidiaries into markets that are distinct from those served by the subsidiary banks of the holding companies". Such market extensions, the Board argued, would lessen risks of tie-ins and would promote competition. For these reasons, while the Board preferred that the phrase, "closely related", be changed to read "functionally related", it said in the following quotation that these ends could be secured by deleting the three-word phrase "the business of":

> If the conferees prefer to keep "closely related" in the language of the statute, our objective would be served by changing the words "the business of banking or of managing or controlling banks" to read "banking or managing or controlling banks".

The fact that the Committee adopted the Board's suggested revision may count importantly when the courts come to consider the issue.

In any case, I am sure that the Board will indicate very soon some of the activities it considers permissible under the new law. I am certainly hopeful that bank holding companies will be permitted to offer many financially related services. I again express my personal support—as I did last May—for permitting bank holding companies some product diversification and I plan to continue my efforts toward this end.

As I indicated earlier, Section 4(c)(8) now requires that the Board, in determining whether an activity is a proper incident to banking, consider whether its performance by a proposed affiliate "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices". In essence, this new test requires that every nonbank acquisition be found to yield positive net benefits to the public. It appears on its face to be more stringent than the statutory standards applicable to commercial bank mergers and acquisitions: Those standards permit bank regulators to approve a merger or acquisition even though competition may be lessened, unless the lessening of competition is substantial. If it is substantial, the regulator may approve the merger or acquisition only if the substantial anticompetitive effects are "clearly outweighed" by benefits to the convenience and needs of the community to be served. For nonbank acquisitions, however, each proposal must show net benefits to the public.

To what degree the language of the 1970 amendments will prove to be genuinely more severe, however, is uncertain. Despite the seemingly easier test for bank acquisitions, bank regulators have been loath to approve bank consolidations that would appear to have adverse competitive effects, even if not substantial, without offsetting gains to the public. Therefore, I would think that had commercial bank mergers been subject to the seemingly more severe test of net public benefit, the pattern of regulatory approval might not have been very different.

Nevertheless, the test may be construed to be more severe, and that fact suggests that banking organizations take particular care in the way in which they enter new areas of endeavor. I would surmise that leading banking organizations would probably meet regulatory resistance in attempts to acquire leading firms in nonbank fields. This would be particularly true if the holding company has the management and financial resources to enter that bank-related field *de novo* or through the acquisition of a relatively small firm. The experience of bank merger and acquisition cases suggests that it may not be an easy task for an applicant to demonstrate public convenience or efficiency offsets to damaging competitive effects.

All things considered, I am pleased with the provisions of the new law. Despite some remaining uncertainties, the new law should provide to banking organizations the basis for a significant degree of diversification of financial services and should permit companies to offer such services in geographical markets that they have never served before. On the other hand, the public benefit test may limit severely their ability to enter some geographical and service markets, except through the establishment of a *de novo* subsidiary. As banks take advantage of these opportunities, they should enhance the competitive environment of our banking and financial system and contribute to a more efficient allocation of financial resources in the economy. I also recognize that the new legislation, of course, adds greatly to the regulatory responsibilities of the Federal Reserve System. We are preparing to handle this challenge, and we hope to play a constructive role in shaping a more competitive and more efficiently functioning financial system.

Let's turn for a moment to the more general problem the entire nation faces: inflation and unemployment. Both the problem and its solution are bound to have profound effects on your own banking operations. As we look back on the past two years, we find that fiscal and monetary policies have played a major role in eliminating excessive demand pressure on the economy. Thus, one primary condition for a reduction in the rate of inflation has been satisfied—yet signs of slackening in price rises are not yet convincing, and inflation continues to be very much of a challenge, now fueled largely by grossly excessive wage settlements that bear no relation to any reasonable expectation of productivity gains. At the same time, sluggish real growth of the economy has brought unemployment into a range that is obviously worrisome and would be quite unsatisfactory over an extended period.

During these same two years, the sluggishness of business has reflected in large measure a weakening of confidence on the part both of businessmen and of consumers. This loss of confidence in turn may be attributed to slower business itself and to a variety of other factors, including perplexity over the persistence of inflation while unemployment was growing and mounting concern with international developments. Confidence was also hurt by accumulating evidence, culminating in the summer of 1970, that financial strains were placing in jeopardy large corporations that had been thought of as more or less invulnerable and were also threatening the viability of important financial markets. It was both logical and proper, under these conditions, that fiscal and monetary policies should move as they did in a distinctly easier direction in 1970, after the severe restraint of the preceding year. As we look ahead, it seems likely that fiscal policy will tend to become more expansive; and it seems clear that monetary policy will have to be applied with great caution in the face of our twin problems of inflation and unemployment. It would certainly be a great mistake to go all out for rapid economic expansion, for this would virtually guarantee a resurgence of inflation—and, in the longer run, a new and more severe problem of unemployment.

But the very need for caution in using rapid credit expansion as the way to cut unemployment to tolerable levels points up the need to search hard for means other than fiscal and monetary policies for affecting directly both unemployment and wage and price decisions. Thus, not only is it important to exploit various attacks on "structural" unemployment, it is also essential, in my judgment, to try some variant of "incomes policy" as a way of breaking the inflation spiral. While I am by no means sure what the best detailed plan should be, it does seem to me that it should be simple and easily understood, that it should set definite targets, and that it should be temporary. An effective incomes policy would certainly give monetary policy greater scope to accommodate business recovery, with all that that may imply in the way of interest rate levels and availability of credit.

I have, of course, been speaking in broad terms of our major domestic economic problems—but I would not like to leave you without touching briefly on the international aspects which are very closely intertwined with the domestic. Some of you may be tempted to think of our balance-of-payments problems as very remote from your day-to-day task of carrying on sound banking activities. Another possible reason for the tendency to downgrade this topic is the fact that our balance-of-payments problem has been with us in more or less acute form for some twelve years, and it hasn't yet brought on anything like disaster. And then there are others who dismiss the subject by pointing to the size of the United States economy and arguing that other countries are obliged to use the dollar as the base of their foreign trade and investment whether they like it or not, so why worry about the balance of payments? I am quite sure these are false comforts. If we continue to run huge payments deficits we shall be courting, at the very least, all kinds of restraints abroad on United States investment and trade, which are bound to react on business conditions here. And it is quite possible that continuing balance-of-payments deficits could also lead to very heavy speculative movements against the dollar. Vast foreign holdings of dollars in the Euro-dollar market and in our stock market would provide ample fuel for such speculation, and widespread effects could be felt in our financial markets as well as in business conditions in this country.

The only real hope of a better United States balance of payments lies in a successful attack on inflation, which would check imports by preventing excessive demand in the economy and would preserve the competitive position of American exports by keeping cost and price increases to a minimum. Since all the major industrial countries are suffering in greater or less degree from inflation, we could achieve real results just by doing a little better than most other countries in fighting inflation. In view of the tremendous stakes involved both at home and abroad, such progress should well justify the effort.

Nineteen-seventy was a rather discouraging year. The new year offers a great opportunity for improvement. I hope that all elements in the country, including the very influential banking community, will join forces to bring inflation under control at long last and, thereby, restore sustainable real growth in the economy.