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COMPETITION IN BANKING ACT OF 1976

GOVERNMENT

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HEARINGS BEFORE THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-FOURTH CONGRESS

SECOND SESSION

ON

S. 2721

TO AMEND THE BANK HOLDING COMPANY ACT AND THE
BANK MERGER ACT TO RESTRICT THE ACTIVITIES IN WHICH
REGISTERED BANK HOLDING COMPANIES MAY ENGAGE AND
TO CONTROL THE ACQUISITION OF BANKS BY BANK HOLDING
COMPANIES AND OTHER BANKS

MARCH 4 AND 5, 1976

Printed for the use of the Committee on Banking,
Housing and Urban Affairs

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U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1976

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COMPETITION IN BANKING ACT OF 1976

THURSDAY, MARCH 4, 1976

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 10 a.m., pursuant to call, in room 5302, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Stevenson, Morgan, and Garn.

The CHAIRMAN. The committee will come to order.

Other Senators will be here shortly I understand.

Today we begin hearings on S. 2721, the Competition in Banking Act of 1975.

The bill has two important interrelated thrusts. First, the bill would flatly prohibit any bank acquisition by an organization controlling 20 percent or more of the banking assets in any State and would empower the bank regulatory agencies to deny any anticompetitive merger or acquisition whether or not the transaction would violate the Clayton Antitrust Act. Second, the bill would amend the Bank Holding Company Act by restricting the so-called nonbanking activities of bank holding companies to those which are directly related to banking and in which specific public benefits are shown. The bill contains a number of important procedural safeguards to insure due process protection to competitors of banking institutions who may be adversely affected by bank holding company expansion.

Bank holding companies have experienced explosive growth over the last several years and have come to dominate the business of banking in the Nation. During the period 1968-74, for example, holding company control of bank deposits went from 38 percent to 71 percent. Over this period, the Federal Reserve has permitted bank holding companies to engage in 17 separate nonbanking activities from insurance agency and underwriting services to leasing, data processing, and securities activities.

The trend toward dominance of our financial markets by bank holding companies is magnified by the trend toward the oligopolization of the banking system by a few large banks. Over the course of the past 25 years, the 10 and 25 largest banking institutions have increased their share of the Nation's bank deposits from 20 percent and 30 percent respectively to 29 percent and 39 percent.

This twin trend is no mere matter of esoteric academic concern. Where markets become concentrated, competition is reduced and we all pay in terms of higher prices, reduced services and less control

over our daily lives. I think that the problem is that in our free system we all favor competition and should and want to do all we can to make competition as vigorous and effective as we can. We also want that competition and should insist that that competition is fair. Where the banks move in to compete with nonbanking firms, the banks have a clear and obvious capital advantage. They are able to use the capital which the law permits them to hold for others as deposits and which we have found recently is as much as 90 or 95 percent of their entire resources, as compared to only 5 or 10 percent of the stockholders' money in a bank. So they can use the capital provided under the law which only banks can use. Furthermore, the banks enjoy a peculiar protection from competition from other banks. It's one of the very few industries where competition is restricted on the basis of a regulatory body which will only permit another competitor to come in if the regulatory body finds the community needs another bank. That isn't true in the insurance business. It's not true in the auto leasing business. It's not true in almost any other business we have in this country. If somebody wants to move into that market he can move into that market and he's not restricted by any regulatory body. So that banks have that protection against competition from other banks and they have an immense capital advantage when they compete elsewhere.

Today and tomorrow we will hear testimony from spokesmen for a number of commercial industries into which bank holding companies have been allowed to penetrate and to erode the line of demarcation historically followed between finance and commerce.

The gentlemen from these industries, I hope will direct their attention to the effect on competition in their industries by the entry into their industries of banking organizations and shed light of the proper line of demarcation between banking and commerce in their industries.

We shall begin by hearing a panel of spokesmen from the insurance industry. Our witnesses are Mr. Edward J. Kremer, Independent Insurance Agents of America; Mr. Jack Bobo, National Association of Life Underwriters; and Mr. Edward J. Schmuck, on behalf of a number of nationally known insurance companies. We will start off with Mr. Kremer. But let us insert a copy of S. 2721 in the record at this point.

[The bill follows:]

1 (b) the explosive growth of bank holding com-
2 panies has resulted in an increasing share of such bank-
3 ing resources coming under the control of those institu-
4 tions; and

5 (c) bank holding companies have extended their
6 services into product markets beyond those directly re-
7 lated to banking, thereby eroding the line between
8 banking and commerce in the Nation: (i) in offering
9 insurance agency and underwriting services, (ii) in
10 offering leasing, accounting, travel, and courier services,
11 (iii) in offering management and data processing serv-
12 ice, and (iv) in marketing securities; and

13 (d) credit resources of the Nation have been mis-
14 allocated by the activities of bank holding companies
15 and the Federal Reserve has not adequately protected
16 the public interest in approving activities in which bank
17 holding companies could engage and the Federal Re-
18 serve has not maintained continued oversight over the
19 activities of bank holding companies in a manner which
20 protects the public interest.

21 STANDARDS FOR BANK MERGERS

22 SEC. 101. Paragraph (5) of section 18 (c) of the Fed-
23 eral Deposit Insurance Act is amended to read as follows:

24 “(5) The responsible agency shall not approve—

25 “(A) any proposed merger transaction which

1 would result in a monopoly, or which would be in
2 furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States, or

5 “(B) any other proposed merger transaction whose
6 effect in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in
8 restraint of trade, unless it finds that the anticompetitive effects of the proposed transaction are clearly outweighed in the public interest by the probable effect of
11 the transaction in meeting the convenience and needs
12 of the community to be served, or

14 “(C) any other proposed merger transaction if,
15 either as a result of such merger transaction or because
16 of its preexisting assets, the acquiring, assuming, or
17 resulting bank would upon consummation of transaction hold more than 20 per centum of the total
18 assets held by all banks located in the State in which
19 such bank is located: *Provided, however,* That this subparagraph shall not apply to any merger or consolidation of banks in which the responsible agency finds
21 that immediate action is necessary to prevent the probable failure of a bank and that a less anticompetitive
22 alternative is not available.

1 For purposes of this paragraph, if any company has, or
2 upon consummation of the merger transaction would have,
3 control, as defined in section 2 of the Bank Holding Com-
4 pany Act of 1956, over the acquiring, assuming, or result-
5 ing bank, total assets held by all banks over which the
6 same company has such control shall be attributed to such
7 bank. As used in this paragraph, the terms 'bank' and
8 'company' have the meaning ascribed to such terms in sec-
9 tion 2 of the Bank Holding Company Act of 1956. In
10 every case, the responsible agency shall take into consider-
11 ation the financial and managerial resources and future pros-
12 pects of the existing and proposed institutions, and the con-
13 venience and needs of the community to be served. Nothing
14 contained in this paragraph or in any other paragraph of
15 this subsection shall prevent the responsible agency from
16 disapproving any other merger transaction on the grounds
17 that such transaction would have adverse effects on compe-
18 tition or concentration in any market, region, State, or other
19 area which, although not requiring disapproval under sub-
20 paragraph (A), (B), or (C) of this paragraph, are not
21 clearly outweighed in the public interest by the probable
22 effect of the transaction in meeting the convenience and
23 needs of the community to be served.”.

24 SEC. 102. Section 18(c) of the Federal Deposit In-
25 surance Act is amended by inserting in paragraph (8) after

1 “(the Clayton Act,” the words “paragraph (9) of this sub-
2 section, and”; and by renumbering section “(9)” section
3 “10”; and by adding a new paragraph “(9)” as follows:

4 “(9) (A) Every merger transaction having the
5 effects set forth in subparagraph (C) of paragraph (5)
6 of this subparagraph is declared to be illegal.

7 “(B) The district courts of the United States have juris-
8 diction to prevent and restrain violations of subparagraph
9 (A) of this paragraph, and it is the duty of the United States
10 attorneys, under the direction of the Attorney General, to
11 institute proceedings in equity to prevent and restrain such
12 violations. The proceedings may be by way of a petition set-
13 ting forth the case and praying that the violation be enjoined
14 or otherwise prohibited. When the parties complained of
15 have been duly notified of the petition, the court shall pro-
16 ceed, as soon as possible, to the hearing and determination of
17 the case. While the petition is pending, and before final de-
18 cree, the court may at any time make such temporary re-
19 straining order or prohibition as it deems just. Whenever it
20 appears to the court that the ends of justice require that other
21 parties be brought before it, the court may cause them to be
22 summoned whether or not they reside in the district in which
23 the court is held, and subpoenas to that end may be served in
24 any district by the marshal thereof.

25 “(C) In any action brought by or on behalf of the

1 United States under subparagraph (A) of this paragraph,
2 subpoenas for witnesses may run into any district, but no writ
3 of subpoena may issue for witnesses living out of the district
4 in which the court is held at a greater distance than one
5 hundred miles from the place of holding the same without the
6 prior permission of the trial court upon proper application
7 and cause shown.

8 “(D) Nothing contained in this paragraph shall be con-
9 strued as affecting in any manner the right of the United
10 States or any other party to bring an action under any other
11 law of the United States or of any State, including any right
12 which may exist in addition to specific statutory authority,
13 challenging the legality of any merger transaction which may
14 be proscribed by this paragraph.”.

15 STANDARDS FOR BANK HOLDING COMPANY ACQUISITIONS
16 OF BANKS

17 SEC. 201. Paragraph (c) of section 3 of the Bank Hold-
18 ing Company Act of 1956 is amended to read as follows:

19 “(c) The Board shall not approve—

20 “(1) any acquisition or merger or consolidation
21 under this section which would result in a monopoly, or
22 which would be in furtherance of any combination or
23 conspiracy to monopolize or to attempt to monopolize
24 the business of banking in any part of the United States,
25 or

1 “(2) any other proposed acquisition or merger or
2 consolidation under this section whose effect in any sec-
3 tion of the country may be substantially to lessen com-
4 petition, or to tend to create a monopoly, or which in
5 any other manner would be in restraint of trade, unless
6 it finds that the anticompetitive effects of the proposed
7 transaction are clearly outweighed in the public in-
8 terest by the probable effect of the transaction in meeting
9 the convenience and needs of the community to be
10 served, or

11 “(3) any other proposed acquisition, merger, or
12 consolidation transaction under his section if, either as a
13 result of such transaction or because of the preexisting
14 bank assets over which it has control, the acquiring or
15 resulting company would have control over aggregate
16 total banking assets exceeding 20 per centum of the total
17 banking assets held by all banks and bank holding com-
18 panies located in the State in which such company is
19 located: *Provided, however,* That this paragraph shall
20 not apply to any acquisition, merger, or consolidation
21 transaction in which the Board finds that immediate ac-
22 tion is necessary to prevent the probable failure of a
23 bank and that a less anticompetitive alternative is not
24 available.

25 In every case, the Board shall take into consideration the

1 financial and managerial resources and future prospects of
2 the company or companies and the banks concerned, and the
3 convenience and needs of the community to be served. Noth-
4 ing contained in this chapter shall prevent the Board from
5 disapproving any other acquisition, merger, or consolidation
6 transaction on the grounds that such transaction would have
7 adverse effects on competition or concentration in any mar-
8 ket, region, State, or other area which, although not requir-
9 ing disapproval under paragraph (1), (2), or (3) of this
10 subsection, are not clearly outweighed in the public interest
11 by the probable effect of the transaction in meeting the con-
12 venience and needs of the community to be served.”.

13 SEC. 202. The Bank Holding Company Act of 1956 is
14 amended by inserting in section 1849 (f) after “(the Clay-
15 ton Act,” the words “subsection (g) of this section”; and
16 by adding to section 1849 a new section (g) as follows:

17 “(g) (1) Every acquisition, merger, or consolidation
18 transaction having the effects set forth in paragraph (3) of
19 subsection (c) of section 3 of this chapter is declared to be
20 illegal.

21 “(2) The district courts of the United States have juris-
22 diction to prevent and restrain violations of paragraph (1)
23 of this subsection, and it is the duty of the United States
24 attorneys, under the direction of the Attorney General, to
25 institute proceedings in equity to prevent and restrain such

1. violations. The proceedings may be by way of a petition
2 setting forth the case and praying that the violation be en-
3 joined or otherwise prohibited. When the parties complained
4 of have been duly notified of the petition, the court shall
5 proceed, as soon as possible, to the hearing and determina-
6 tion of the case. While the petition is pending, and before
7 final decree, the court may at any time make such tempo-
8 rary restraining order or prohibition as it deems just. When-
9 ever it appears to the court that the ends of justice require
10 that other parties be brought before it, the court may cause
11 them to be summoned whether or not they reside in the dis-
12 trict in which the court is held, and subpoenas to that end may
13 be served in any district by the marshal thereof.

14 “(3) In any action brought by or on behalf of the
15 United States under paragraph (1) of this subsection, sub-
16 penas for witnesses may run into any district, but no writ
17 of subpoena may issue for witnesses living out of the district
18 in which the court is held at a greater distance than one
19 hundred miles from the place of holding the same without
20 the prior permission of the trial court upon proper applica-
21 tion and cause shown.

22 “(4) Nothing contained in this subsection shall be con-
23 strued as affecting in any manner the right of the United
24 States or any other party to bring an action under any other

1 law of the United States or of any State, including any right
2 which may exist in addition to specific statutory authority,
3 challenging the legality of any acquisition, merger, or con-
4 solidation transaction which may be proscribed by this
5 subsection.”.

6 STANDARDS FOR BANK HOLDING COMPANY ENTRY INTO

7 BANK RELATED ACTIVITIES

8 SEC. 301. (a) Section 4(c) (8) of the Bank Holding
9 Company Act of 1956 is amended to read as follows:

10 “(8) shares of any company the activities of which
11 the Board, on the record and after due notice and oppor-
12 tunity for hearing, has determined (by order or regula-
13 tion) —

14 “(A) to be so closely and directly related to
15 banking or managing or controlling banks as to be
16 a proper and necessary incident thereto, and

17 “(B) is likely to produce substantial benefits
18 to the public which clearly and significantly out-
19 weigh possible adverse effects. For the purposes of
20 this subparagraph, (i) the term ‘substantial bene-
21 fits to the public’ includes increased competition over
22 the course of time and greater convenience or gains
23 in efficiency of operation that will substantially bene-
24 fit the public, and (ii) the term ‘adverse effects’ in-
25 cludes undue concentration of economic or financial

1 resources, decreased competition over the course of
2 time, unfair competition conflicts of interest, unsafe
3 or unsound banking or business practices, risk to the
4 financial soundness of a bank holding company or its
5 banking subsidiaries, and interference with the
6 primary responsibility of a bank holding company
7 or its banking subsidiary to provide effective bank-
8 ing services to the public. For the purposes of de-
9 termining in specific cases whether the performance
10 of a particular activity by an affiliate of a bank
11 holding company is likely to produce substantial
12 benefits to the public which clearly and significantly
13 outweigh possible adverse effects, the Board, in ad-
14 dition to its other considerations, shall take into
15 consideration the relative economic size and market
16 power of the bank holding company and that of
17 those with whom the affiliate would compete.”.

18 (b) (1) Notwithstanding the provisions of subsection
19 (a), and subject to the provisions of subparagraph (2) of
20 this subsection, a bank holding company may continue to
21 engage in those activities in which it directly or through a
22 subsidiary (A) was lawfully engaged on November 1, 1975
23 (or on a date subsequent thereto in the case of activities

1 carried on as the result of the acquisition by such bank hold-
2 ing company or subsidiary thereof, pursuant to a binding
3 written contract entered into on or before November 1, 1975,
4 of another company engaged in such activities at the time
5 of the acquisition), and (B) has been continuously engaged
6 since November 1, 1975 (or such subsequent date), except
7 that such a bank holding company shall not permit the scope
8 or size (in terms of volume of business) of those activities
9 to expand to any significant degree.

10 (2) The Federal Reserve Board by order or regula-
11 tion, after opportunity for hearing, may terminate the
12 authority conferred by subparagraph (1) on any bank
13 holding company to engage directly or through a subsid-
14 iary in any activity otherwise permitted by subparagraph
15 (1) if the Board determines, having due regard for the
16 purposes of this Act, that such action is necessary to pre-
17 vent undue concentration of economic or financial resources,
18 decreased competition over the course of time, unfair com-
19 petition, conflicts of interest, unsafe or unsound banking or
20 business practices, risk to the financial soundness of a bank
21 holding company or its banking subsidiaries, or interfer-
22 ence with the primary responsibility of a bank holding com-
23 pany or its banking subsidiary to provide effective banking
24 services to the public.

1 UNIFORM APPLICATION OF STANDARDS GOVERNING
2 ENTRY INTO BANK RELATED FIELDS

3 SEC. 401. (a) Subject to the provisions of subsection
4 (b), no national bank shall directly or through a subsidiary
5 engage in any activity which is found—

6 (1) pursuant to a regulation of the Federal Re-
7 serve Board issued after the effective date of this Act
8 to be an improper activity for bank holding companies
9 under section 4 (c) (8) of the Bank Holding Company
10 Act of 1956, or

11 (2) pursuant to an order of the Federal Reserve
12 Board issued after the effective date of this Act to be
13 an improper activity for the bank holding company of
14 which such national bank is a subsidiary.

15 (b) Nothing contained in this section shall be inter-
16 preted or construed as authorizing a national bank to
17 engage in any activity prohibited to it under any other
18 provision of law.

19 STANDARDS FOR SOUND AND COMPETITIVE FINANCING
20 OF NONBANKING ACTIVITIES

21 SEC. 501. (a) Section 4 of the Bank Holding Company
22 Act of 1956 is amended by inserting at the end thereof the
23 following new subsection:

24 “(f) In keeping with its responsibilities to administer

1 and carry out the purposes of this Act, and with particular
2 attention to the standards established under subparagraph
3 (8) of subsection (c) of this section, the Board shall require,
4 both in connection with a bank holding company application
5 to engage in a particular activity and in connection with the
6 Board's ongoing supervision of bank holding companies,
7 that (1) bank holding companies and their subsidiaries be
8 capitalized and otherwise financed in a safe and sound
9 manner, and (2) bank subsidiaries of bank holding com-
10 panies refrain from discriminating in favor of their parent
11 holding company or their affiliated subsidiaries in the making
12 of loans or in the establishing of terms and conditions of
13 credit.

14 (b) Subsection (c) of section 5 of the Bank Holding
15 Company Act of 1956 is amended by striking out "(c)"
16 and inserting in lieu thereof "(c) (1)" and by inserting at
17 the end of such subsection the following new subparagraph:

18 "(2) In addition to such other reports as the Board may
19 from time to time require, the Board shall require each bank
20 holding company to submit to the Board each year a report
21 detailing the terms and conditions of all intercompany loans
22 and investments, as between the bank holding company and
23 its subsidiaries and as between any such subsidiaries, made
24 during the twelve-month period immediately preceding such

1 report. The Board shall make such reports available to the
2 public.”.

3 ADMINISTRATIVE PROCEDURES AND JUDICIAL REVIEW

4 SEC. 601. (a) The Bank Holding Company Act of
5 1956 is amended by redesignating sections 9, 10, 11, and 12
6 as sections 10, 11, 12, and 13, respectively, and by inserting
7 immediately after section 8 the following new section:

8 “SEC. 9. (a) The provisions of subchapter II of chapter
9 5 of title 5 of the United States Code (relating to adminis-
10 trative procedure) shall apply with respect to all Board pro-
11 ceedings under section 4 (c) (8).

12 “(b) All Board determinations (whether by order or
13 regulation) under section 4 (c) (8) shall be made on the
14 record after opportunity for hearing, and the provisions of
15 sections 556 and 557 of title 5 of the United States Code
16 shall apply with respect thereto. The Board shall give all
17 interested persons an opportunity to participate in any such
18 hearing.

19 “(c) (1) In connection with any proceeding under sec-
20 tion 4 (c) (8), no person shall, directly or indirectly, make
21 or attempt to make any ex parte communication in connec-
22 tion with the subject matter of any such proceeding to any
23 member of the Board or any member of the Board staff par-
24 ticipating in such proceeding.

1 “(2) No application made under section 4 (c) (8) shall
2 be held or considered to be an application for an initial
3 license within the meaning of subsection (d) of section 554
4 of title 5 of the United States Code.

5 “(d) In connection with any proceeding under section
6 4 (c) (8) to which the requirements of sections 556 and 557
7 of title 5 of the United States Code are being applied, any
8 interested person participating in such proceeding may call
9 upon (1) the Board, or, (2) in the case of the consideration
10 of an application, the applicant, for any information or docu-
11 ments, not privileged, for purposes of discovery or for use as
12 evidence. In addition, in any such proceeding where there
13 is an absence of relevant information, the Board, upon its
14 own motion or that of any interested person participating in
15 such proceeding, shall undertake such studies (and make
16 reports thereon available) as will provide the relevant infor-
17 mation required.”.

18 (b) Section 9 of the Bank Holding Company Act of
19 1956 (as in effect immediately prior to the enactment of
20 this Act) is amended (1) by inserting “or regulation” im-
21 mediately after “order” each place that it appears, and (2)
22 by striking out “as provided in section 2112 of title 28,
23 United States Code” and inserting in lieu thereof the follow-
24 ing: “in the same manner as provided in section 2112 of

1 title 28, United States Code, with respect to orders of ad-
2 ministrative agencies”.

3 PUBLIC'S RIGHT TO PETITION FOR MODIFICATION OF
4 ORDERS AND REGULATIONS

5 SEC. 701. The Bank Holding Company Act of 1956
6 (as amended by section 501 of this Act) is further amended
7 by inserting at the end of the new section 9 thereof the fol-
8 lowing new subsection:

9 “(c) (1) Any interested person, including a consumer
10 or consumer organization, may petition the Board to com-
11 mence a proceeding to consider the issuance, amendment, or
12 revocation of an order or regulation promulgated under the
13 authority of section 4 (c) (8). Such petition shall set forth
14 (a) facts which it claimed established that the issuance,
15 amendment, or revocation of an order or regulation is neces-
16 sary, and (b) a description of the substance of the amend-
17 ment or of the order or regulation it is claimed should be
18 issued, as the case may be.

19 “(2) The Board may conduct a public hearing or may
20 conduct such investigation or proceeding as it deems appro-
21 priate in order to determine whether or not such petition
22 should be granted. Facts which warrant the issuance, amend-
23 ment, or revocation of an order or regulation shall include,
24 in addition to such other matters as the Board may from

1 time to time determine to be appropriate, the following
2 matters:

3 “(A) a finding that a particular activity conducted
4 on the part of a bank holding company or its subsidiary
5 fails to conform to the scope of the activity for which
6 Board approval was originally given;

7 “(B) a finding that a particular activity conducted
8 on the part of a bank holding company or its subsidiary
9 fails to conform to new or amended Board orders or reg-
10 ulations or judicial determinations altering the scope of
11 the activity for which Board approval was originally
12 given;

13 “(C) a finding that the continued conduct of a par-
14 ticular activity on the part of a bank holding company
15 or its subsidiary has ceased to produce, within the mean-
16 ing of section 4 (c) (8), substantial benefits to the pub-
17 lic which clearly and significantly outweigh possible ad-
18 verse effects; or

19 “(D) a finding that the continued conduct of a
20 particular activity on the part of a bank holding company
21 or its subsidiary otherwise violates the standards estab-
22 lished under section 4 (c) (8) for permissible bank hold-
23 ing company activity.

1 “(3) Within one hundred and twenty days after filing
2 of a petition referred to in subparagraph (1), the Board
3 shall either grant or deny the petition. If the Board grants
4 such petition, it shall promptly proceed to determine, on
5 the record and after opportunity for hearing, whether to
6 issue, amend, or revoke such order or regulation. If the Board
7 denies such petition, it shall publish in the Federal Register
8 its reasons for such denial.

9 “(4) If the Board denies such petition, or if the
10 Board fails to grant or deny such petition within one
11 hundred and twenty days after the filing of the petition,
12 the petitioner may commence a civil action in a United
13 States district court to compel the Board to grant such pe-
14 tition. Any such action shall be filed within sixty days after
15 the Board's denial of the petition, or, if the Board fails to
16 grant or deny the petition within one hundred and twenty
17 days after the filing of the petition, within sixty days after
18 the expiration of the one hundred and twenty day period.
19 If the petitioner can demonstrate to the satisfaction of the
20 court, by a preponderance of evidence in a de novo pro-
21 ceeding before such court, that sufficient facts exist to justify
22 the granting of the petition, the court shall order the Board
23 to grant such petition.

1 “(5) In any action under this subsection, the district
2 court shall have no authority to compel the Board to take
3 any action other than to grant such a petition.”.

4 EFFECTIVE DATE

5 SEC. 801. The Act and the amendments made by this
6 Act shall take effect upon the expiration of ninety days
7 following the date of enactment of this Act.

STATEMENT OF EDWARD J. KREMER, INDEPENDENT INSURANCE
AGENTS OF AMERICA

Mr. KREMER. Thank you, Mr. Chairman.

In anticipation that you would want the oral testimony to be brief this morning, we have capsulized a rather sizable document that has a lot of supporting information in it.

The CHAIRMAN. I must say, Mr. Kremer, that's a most impressive document. I won't promise to read every word of it, but I have had a chance to go through it and I think you do a fine job of providing very helpful material.

Mr. KREMER. It's about 80 percent appendices, Mr. Chairman, but we hope it will be of some value.

My name is Edward J. Kremer, and I'm chairman of the Federal Affairs Committee of the Independent Insurance Agents of America and if that name is not too familiar I should point out that up until January of this year we were known as the National Association of Insurance Agents.

I'm an independent insurance agent and my office is in Salisbury, Md. Also with me today are Mr. John Neville, our general counsel; Mr. Thomas Wilson, Mr. Stewart Halper, who are also counsel.

We welcome this opportunity to testify in support of S. 2721, a bill which takes a step in the right direction toward clarifying and strengthening the current law limiting the participation of banking organizations in nonbanking activities.

In that connection, we would like to express our gratitude to this committee for the invitation to express our views on these matters of vital importance to our economy.

The Independent Insurance Agents of America is the national association of independent property and casualty insurance agents. The association is composed of 50 State associations which represent more than 33,000 insurance agencies, and approximately 150,000 insurance agents across the country. While the members of IIAA vary greatly in size, they are mostly comprised of smaller businesses. The agents take considerable pride in being in an industry where small business organization has been able to efficiently serve the insurance needs of the public. This serving of the public has been accomplished through the efficiencies of highly competitive retail markets characterized by large numbers of conveniently located agencies from which the public is able to purchase insurance.

Senator MORGAN. Mr. Chairman, is Mr. Kremer reading from a document that we are supposed to have?

The CHAIRMAN. I beg your pardon; the document should be on your desk. It's the large document here. This is Mr. Kremer. This is the first paper. He's only reading the first paper. The rest is going to be put in the record.

Senator MORGAN. You're just summarizing?

Mr. KREMER. Yes, sir, I most certainly am.

Senator MORGAN. I thought you had a prepared summary of it.

Mr. KREMER. No, sir. This is just excerpts from that document.

The CHAIRMAN. Mr. Kremer is going to try to confine his remarks to about 10 minutes.

Mr. KREMER. Yes, sir. That's true. Consequently, it has been concerned with the increasing attempts by large banking organizations to gain entry into that industry. IIAA's concern has precipitated our involvement in substantial litigation. Because the cases to which we refer are still in process before the courts, we cannot, of course, comment upon them. However, both the historic trend and recent developments in the banking industry suggest the need for immediate comprehensive banking reform legislation.

In recent years there have been spectacular failures among such banking holding companies as United States Bank of San Diego, Franklin National Bank of New York, and most recently, Hamilton Bancshares Inc. of Chattanooga, Tenn. In addition, various disquieting reports concerning the questionable soundness of First National City Bank, Chase Manhattan and other large banking institutions have brought the need for banking reform into sharp focus.

There must be renewed recognition of the unique economic characteristics of banking institutions. In the first place, the entry into banking markets is strictly controlled by State and Federal regulatory authorities. The very substantial competitive advantage conferred upon banks by the chartering process is then amplified by the fact that banks receive enormous infusions of free money in the form of demand deposits upon which they pay no interest. Banking organizations, in effect, get public funds which they can then use to drive small business out of business.

The inherent advantage of bank monopoly power is further amplified by the lenders' power over credit. The structural realities of the situation produced the danger that the bank may coerce borrowers into purchasing affiliated nonbanking services as a condition of the extension of credit or as a condition for reduction of interest rates assessed on the loan.

An additional point which is perhaps more insidious since it is more difficult to detect and therefore to prevent is the possibility that borrowers will voluntarily purchase affiliated nonbanking services in an effort to improve or protect their status with the banking organization.

As far as the sale of property and casualty insurance is particularly concerned, the many faceted operations of bank holding companies create special problems. The number of holding company activities and the variety of borrowers and loan transactions with which holding companies deal presents them with the ability to capture more lines of insurance and more consumers than any non-affiliated agent would ever be afforded through cross-selling of bank holding company services. Therefore, the opportunity for growth of an affiliated insurance agency operation is geometric in comparison with a nonaffiliated agency. What is more, the principal function of an insurance agent is to provide insurance purchasers with independent advice with respect to their insurance needs. Since the interest of banking organizations and borrowers in collateralized property is often different, it is obvious that the involvement of an affiliated agent in a particular loan transaction places the affiliated agent in a classic conflict of interest posture.

Finally, the possession by banking organizations of information which is crucial to the business operations of their depositors, such as customer lists, insurance expiration dates, et cetera, provides them with the opportunity to permit their nonbanking affiliates to use the information to obtain an important competitive advantage over the nonaffiliated businesses with which they compete.

S. 2721 is a step in the right direction toward meaningful bank holding company reform. With the inclusion of the amendments we propose, S. 2721 would be more strongly proconsumer by protecting competition in various nonbanking industries and also more probanking by helping assure the continued soundness of our banking system.

However, in a number of important ways, provision of S. 2721 would help clarify and strengthen the current law restricting bank holding companies from engaging in nonbanking activities. For example, section 301 would amend the existing bank holding company law to limit the kind of activities in which bank holding companies may participate to those which are closely and directly related to banking. In addition, such activities would be permitted to be pursued only where bank holding company participation in the activities would be likely to produce substantial benefits to the public.

For the reasons previously stated, the power of banking organizations over credit is such that to permit them to participate in activities which are not very closely and specifically related to banking is to invite economic preemption by banking organizations of industries with respect to which the public interest would be better served if the banks were kept out.

In this connection, while the language of this provision of S. 2721 brings increased clarity to the current law, it still permits the Federal Reserve Board some latitude of interpretation within which to circumvent the intent of Congress. Given the high degree of sympathy which administrative agencies often feel towards their constituents, in any adjudicatory proceeding before the Federal Reserve Board between a bank holding company making application to engage in a nonbanking activity and nonbanking intervenors seeking to oppose the application, the nonbanking parties are placed at a severe disadvantage.

In addition, in any series of protracted adjudications between bank holding companies and groups of nonbanking entities opposing bank holding company entry into their industries, the war of attrition will almost certainly eventually be won by the bank holding companies, especially where there is a sympathetic regulator involved. This is particularly true in the face of the substantial evidence test under the current law since such tests permits an agency to approve an activity as being in the public interest when the weight of the evidence would compel a different conclusion.

It is for these reasons that IIAA believes that ultimately the only solution to the bank holding company nonbanking problem is one that is made at the legislative level by defining specific activities in which bank holding companies may not engage.

Legislative reform of bank regulatory problems is needed immediately. Since in the battle of attrition being waged by banking organizations with respect to a number of nonbanking activities, including the sale of property and casualty insurance, nonbanking entities ultimately cannot expect to prevail. For this reason, Congress must act promptly.

S. 2721 represents movement in the right direction. However, IIAA believes that S. 2721 should be amended to include specific legislative prohibitions against a bank holding company participation in specified nonbanking activities.

The CHAIRMAN. Thank you very much, Mr. Kremer.

[Complete statement follows:]

STATEMENT OF EDWARD J. KREMER, CHAIRMAN OF THE FEDERAL AFFAIRS COMMITTEE OF THE INDEPENDENT INSURANCE AGENTS OF AMERICA, INC.

Mr. Chairman and Members of the Committee: My name is Edward J. Kremer and I am Chairman of the Federal Affairs Committee of the Independent Insurance Agents of America ("IIAA").¹ We welcome this opportunity to testify in support of S.2721, a bill which takes a step in the right direction toward clarifying and strengthening the current law limiting the participation of banking organizations in nonbanking activities. In that connection, we would like to express our gratitude to this Committee for the invitation to express our views on these matters of vital importance to our economy.²

IIAA is the national association of independent property and casualty insurance agents. The association is composed of 50 state associations which represent more than 33,000 insurance agencies and approximately 150,000 insurance agents across the country. While the members of IIAA vary greatly in size, they are mostly comprised of smaller businesses. The agents take considerable pride in being in an industry where small business organizations have been able efficiently to serve the insurance needs of the public. This serving of the public has been accomplished through the efficiencies of highly competitive retail markets characterized by large numbers of conveniently located agencies from which the public is able to purchase insurance.

IIAA is dedicated to preserving the highly competitive market structure which currently characterizes the sale of property and casualty insurance. Consequently, it has been concerned with the increasing attempts by large banking organizations to gain entry into that industry. IIAA's concern has precipitated our involvement in substantial litigation. Because the cases to which we refer are still in process before the courts, we cannot, of course, comment upon them. However, both the historic trend and recent developments in the banking industry suggest the need for immediate comprehensive banking reform legislation.³

BANK FAILURES AND EXPANSION

In recent years, there have been spectacular failures among such bank holding companies as United States National Bank of San Diego, Franklin National Bank of New York, and, most recently, Hamilton Bancshares, Inc. of Chattanooga, Tennessee. In addition, various disquieting reports concerning the questionable soundness of First National City Bank, Chase Manhattan Bank and other large banking institutions have brought the need for banking reform into sharp focus. In fact, as recently as January 22, 1976, the *New*

¹ IIAA recently changed its name from the National Association of Insurance Agents ("NAIA").

² The questions propounded by Senator Proxmire in his letter to the Chief of the Washington Bureau of IIAA of February 24, 1976, are answered in this statement generally. More specific responses to some of the questions are set forth in the portior of this statement which addresses the specific provisions of S. 2721. See pp. 31-42 *infra*.

³ A chronology of the proceedings since 1970 relating to the bank holding company insurance agency issue is provided in Appendix 8 at p. 68.

York Times published a list of 35 major bank holding companies which the Federal Reserve Board reportedly considers to be "problem bank holding companies."⁴

Furthermore, the recent past has seen a dramatic expansion of large banking organizations, both in terms of the number and size of the banks they control, and in the nature and variety of their nonbanking affiliates. The result has been a concentration of economic resources in bank holding companies and continuing high levels of concentration of banking resources in relevant markets.⁵

There must be a renewed recognition of the unique economic characteristics of banking institutions. In the first place, the entry into banking markets is strictly controlled by state and Federal bank regulatory authorities. Thus, through the bank chartering process, monopoly type power is conferred upon banking institutions at the outset. The very substantial competitive advantage conferred upon banks by the chartering process is then amplified by the fact that banks receive enormous infusions of "free" money in the form of demand deposits upon which they pay no interest. Such funds are in turn loaned out by the banks at a profit and used by the banking organizations to initiate activities in nonbanking areas. Ultimately, what occurs is that public funds are infused into the banking institutions at virtually no cost to the banks and used by such institutions to effect entry into nonbanking businesses. Banking organizations in effect get public funds which they then can use to drive small businesses out of business. It is clear therefore that banking institutions are provided an enormously significant economic edge over the nonbank entities with which they come into competition and that this economic benefit is conferred upon them as quasi-public creatures without any compensating benefit accruing to the public.⁶

The inherent advantage of bank monopoly power is further amplified by the lender's power over credit. Credit, like anything else, is a scarce economic resource, especially in times of tight money. Moreover, it is an essential component of capital formation and thus a crucial factor in the ongoing viability of the economy. Consequently, the union within the same institutional structure of the process of credit extension with nonbanking activities creates the opportunity for the nonbanking profit centers of the banking organization to benefit from the banking affiliate's capital resources and customers. What is worse, the structural realities of the situation produce the danger that the bank may coerce borrowers into purchasing affiliated nonbanking services as a condition of the extension of credit or as a condition for reduction of the interest rate assessed on a loan. An additional possibility, which is perhaps more insidious, since it is more difficult to detect and therefore to prevent, is the possibility that borrowers will voluntarily purchase affiliated nonbanking services in an effort to improve or protect their status with the banking organization. This eventuality could result either from subtle suggestions by loan officers or out of a borrower perception that, in the context of a loan transaction, they are in relation to the bank in an inferior bargaining position. Either occurrence removes the traditional competitive levers of price and service in the area of the nonbanking activity as effective tools of economic efficiency. In the process, owners of smaller businesses will be forced out and fledgling entrepreneurs will have to try to apply their talents and initiative elsewhere.

Furthermore, the ever increasing presence of bank holding companies in nonbanking businesses tends to diminish the quality of bank management and services by forcing the banking function of the organization to share the institution's managerial resources with competing nonbanking profit centers. Moreover, given the degree to which nonbanking affiliates of bank holding companies are caught up in the corporate self-esteem of the holding company, when one of the nonbanking affiliates of the holding company gets into financial

⁴ *New York Times*, January 22, 1976, at 61, col. 1.

⁵ A statistical summary of the expansion of banking institutions in recent years is set forth in Appendix 3 (at p. 45). It should be emphasized, however, that bank holding companies now control 34 of the 100 largest mortgage banking companies, 27 of the 86 largest non-captive finance companies, and 13 of the largest factoring companies. See Talley, "Bank Holding Company Financing", *Conference on Bank Structure and Competition* (Federal Reserve Bank of Chicago), at 128 (1975).

⁶ A more comprehensive discussion of the economic issues raised by bank entry into nonbanking activities is provided at Appendix 2 at p. 42.

difficulty, the holding company often finds itself compelled to bail out the ailing subsidiary. In this way, the bank affiliate of the holding company could be compromised, either by having to make substandard loans to the endangered affiliate or as a result of a perception on the part of the public that perhaps the bank subsidiary of the holding company is also in trouble. Either way, the danger presented to the banking system is obvious.

Finally, as the complexities of banking and nonbanking businesses carried on by banking organizations multiply, less effective management of the banking aspect of the organization occurs. Moreover, the addition to banking organizations of nonbanking businesses makes the already difficult task confronting bank regulators even more so, and increases the chance that banking and nonbanking regulators will come into conflict with one another.

As far as the sale of property and casualty insurance is particularly concerned, the many faceted operations of bank holding companies create special problems.⁷ The number of holding company activities and the variety of borrowers and loan transactions with which holding companies deal, presents them with the ability to capture more lines of insurance and more consumers than any nonaffiliated agent would ever be afforded. Through cross-selling of bank holding company services, therefore, the opportunity for growth of an affiliated insurance agency operation is geometric in comparison with a non-affiliated agency.

What is more, the principal function of an insurance agent is to provide insurance purchasers with independent advice with respect to their insurance needs. Since the interests of banking organizations and borrowers in collateralized property are often different, it is obvious that the involvement of an affiliated agent in a particular loan transaction places the affiliated agent in a classic conflict of interest posture.

Finally, the possession by banking organizations of information which is crucial to the business operations of their depositors (*e.g.*, customer lists, insurance expiration dates, etc.) provides them with the opportunity to permit their nonbanking affiliates to use the information to obtain an important competitive advantage over the nonaffiliated businesses with which they compete.

SEPARATION OF BANKING AND COMMERCE

Over the years, Congress has repeatedly indorsed the separation of banking and commerce within our economic structure.⁸ However, over time, the decisions of the administrative agencies which regulate banks and bank holding companies have blurred this traditional separation. In the interest of the survival of many small businesses which banks are seeking to enter, and the continued viability of our banking and hence our economic system, this trend must be halted and if possible reversed.

Bankers should be made to refocus their mental energies on banking, unfettered by the distractions associated with an increasingly large number of diverse nonbanking operations. In this connection, while HIAA recognizes S.2721 as a step in the right direction, we favor an outright legislative prohibition with respect to bank holding company entry into nonbanking activities. The historic inability of Congress and the courts to supervise the bank regulatory agencies clearly commends this approach.

NONBANKING ACTIVITIES

The consumer is not well served by banking institutions engaging in a broad range of nonbanking activity. The result of bank entry into those activities can reasonably be expected to lessen competition, particularly in industries which are highly competitive and made up of smaller businesses. As stated previously, control over credit may lead to the coercion of borrowers in connection with the purchase of nonbanking services. But, even absent coercion, the control of banking institutions of credit will almost certainly lead to "voluntary" or structural tying of nonbanking services to extensions of credit.

⁷ A more comprehensive discussion of the property and casualty insurance agency industry is provided in Appendix 5. Relevant statistical material concerning the insurance retail industry is provided in Appendix 6 at p. 59.

⁸ The National Bank Act, the Glass-Steagall Act, the Bank Holding Company Act of 1956, and the 1970 Amendments to the Bank Holding Company Act of 1956 bear witness to Congress's intent in that regard.

The history of lender engagement in the sale of credit life insurance is replete with situations which give an indication of the significance with respect to the sale of insurance of the lender's power over credit. For example, a study performed in 1969 by the Federal Reserve Board at the behest of the current Chairman of this Committee revealed that some banks managed to sell credit life insurance in up to 90 percent of their direct consumer loans, even though such insurance is supposedly purely voluntary.⁹ A more recent study by the Federal Trade Commission revealed that some lenders were achieving penetration rates in the sale of credit life insurance that approach 100 percent. Again, this was so even though the purchase of such insurance by borrowers was supposedly voluntary.¹⁰ In fact, that study revealed that one lender (which was not a bank) was apparently achieving penetration rates of 60 percent in the sale of fire insurance.¹¹ The evidence revealed by the Federal Trade Commission study prompted the Commission to conclude.

"The problems we have encountered in the credit life insurance area appear to be in no way alleviated by the present form of Regulation Z. That is, the present provisions of Section 226.4(a)(5) of Regulation Z do not ensure the voluntary election of credit insurance since those creditors who wish to evade the intent of this section may do so by making disclosures which are in ostensible compliance with the Regulation, while orally informing or indicating that the insurance is required."¹²

Under the circumstances, there is no denying that the questions of tying and voluntary tying are both serious and that, once banking institutions are permitted to engage in a nonbanking activities, they are exceedingly difficult to deal with. Given the scarcity of credit and the relationship between lenders and borrowers, that fact should hardly be surprising. After all, unless the coercion attempted by the banking institution is written, it would be exceedingly difficult to prove that any coercion even occurred. Furthermore, the damages a prospective plaintiff might be able to establish may very well not make it worth his while to pursue. Finally, any borrower who may feel that he has been coerced by a bank will be acutely aware of the fact that he will probably be required to borrow money in the future. Such realization will probably make him very reluctant to jeopardize his attractiveness to lenders by bringing suit against one of their number. For all these reasons, Section 106 of the 1970 Amendments of the Bank Holding Company Act of 1956, as amended, 12 U.S.C. § 1975, which prohibits coercive tying and which provides for recovery of treble damages when coercion is proved, cannot realistically be expected to be very effective.

Furthermore, none of the penalties potentially associated with coercive tying have any relevance to the situation where the tie occurs as a result of the borrower's perception that, if he voluntarily places his insurance with a bank's affiliated agency, he will make the bank consider his current loan or some future loan more favorably. As a matter of fact, *Baldwin v. Tuttle*, an Assistant General Counsel of the Federal Reserve Board, has opined that Section 106 of the 1970 Amendments to the Act does not reach the situation of voluntary tying at all.¹³

Finally, the evidence amassed in the 1969 Federal Reserve Board study concerning bank sales of credit life insurance was so significant that the Board concluded:

"... [B]ecause of the inferior bargaining position of the debtor, he may be susceptible to the loan officer's 'suggestions' concerning choice coverage, pre-

⁹ Letter from the Federal Reserve Board of San Francisco to the Federal Reserve Board, dated October 2, 1967. Such letter provides a portion of the basis of the Board's 1969 credit life study. See *Hearings on Consumer Credit Insurance Act of 1969 before the Subcommittee of Financial Institutions of the Committee of Banking and Currency, United States Senate, 91st Cong., 1st Sess. 160-64 (1969)*.

¹⁰ Letter from Charles A. Tobin, Secretary, Federal Trade Commission, to Jeffrey M. Bucher, Member, Federal Reserve Board, November 19, 1974 (FTC Report to the Board in connection with the Board's Annual Report to Congress, 1974). Relevant portions of the letter and an accompanying FTC study are excerpted at Appendix 7 (see p. 61).

¹¹ See *Statement of the Staff of the Division of Special Statutes etc., Federal Trade Commission*, (1974). See also Appendix 7.

¹² Letter from Charles A. Tobin, Secretary, Federal Trade Commission, to Jeffrey M. Bucher, Member Federal Reserve Board, November 19, 1974 (FTC Report to the Board in connection with the Board's Annual Report to Congress, 1974). See Appendix 7.

¹³ Panel, "Bank Holding Company Act etc.", 29 *Business Lawyer* 246-47 (November, 1973) (Remarks of Baldwin v. Tuttle, Assistant General Counsel, Federal Reserve Board).

mium rates, insurer and agent. As a result the debtor easily may receive the impression that his loan application may be more favorably considered if he follows such suggestions."¹⁴

Therefore, there can really be little question that, because of their power over credit, banking organizations which obtain insurance agency affiliates have the opportunity to tie the sale of insurance to extensions of credit. Moreover, there is no means by which tying can effectively be prevented, especially in the case of voluntary tying which has the same economic effect as coerced tying. The ultimate economic effect of tying is, as stated previously, that the price of and the service associated with the sale of insurance are removed as effective tools of economic efficiency, and in the process, especially in the case of industries characterized by smaller businesses, competition will be reduced and concentration will be increased. As is the case in most instances where economic resources are concentrated in the hands of a few, it is the public which ultimately will have to bear the burdens of increased prices and the frustrations of decreased services in the industry in question.

LEGISLATION IS NEEDED

The degree to which legislation which, for once, will consider the important problems of bank holding company participation in nonbanking activities in a coordinated way is currently necessary is provided by a brief review of IIAA's experience with bank regulatory agencies.¹⁵ In this connection, as far as IIAA is concerned, the current law is structured in such a way that nonbanking entities which oppose bank holding company entry into nonbanking activities are exhausted by protracted litigation initiated in an attempt to get the Federal Reserve Board to make meaningful public interest determinations based upon a formal factual record.

In IIAA's case, for example, notwithstanding the expressed statutory provision limiting the authority of national banks to engage in insurance agency activities in communities of 5,000 or less, the Comptroller of the Currency permitted national banks to sell insurance without limitation. The Comptroller's position was challenged and the lower court ruled against him. Finally, in 1968 the Fifth Circuit determined that the Comptroller's grant of authority with respect to insurance agency activities exceeded that permitted by the National Bank Act.¹⁶ In the face of this setback, there was a movement among bank holding companies to circumvent the restrictions of the National Bank Act by attempting to enter the insurance agency business through the bank holding company system. In 1969, IIAA challenged a bank holding company's acquisition of an insurance agency before the Federal Reserve Board. IIAA's challenge was met with the claim that competitors had no "standing" to make such a challenge. After an appeal, IIAA prevailed on this issue whereupon the bank holding company withdrew its application before it could be considered on its merits.

After the enactment of the 1970 Amendment to the Bank Holding Company Act of 1956, the Board determined pursuant to a rulemaking proceeding that certain types of insurance are "closely related" to banking. In promulgating this regulation, Section 225.4(a)(9) of Regulation Y, the Board left the types of insurance included within the regulation largely unspecified. In September 1972, without notice or hearing, it issued an "interpretation" which provided more detailed description of the types of insurance meant to be covered in its previous regulation. After a court challenge in which IIAA contended that the "interpretation" was in actuality an operative decision of the Board, the Board admitted that the "interpretation" was actually only tentative and that the issues would be determined in certain adjudicatory proceedings instituted six months after the "interpretation" was promulgated.

Similarly, two weeks after the Board issued its 1971 determination, it issued another rule without notice or hearing which provided that de novo entries by bank holding companies into insurance agency activities were presumed to result in net benefits to the public. Again, after a court challenge, the Board voluntarily suspended the rule.

¹⁴ *Hearings on Consumer Credit Insurance Act of 1969 etc., supra*, at 163.

¹⁵ See Appendix 8, page 68.

¹⁶ *Saxon v. Georgia Association of Independent Insurance Agents, Inc.*, 399 F.2d 1010 (5th Cir. 1968), *aff'd* 268 F. Supp. 236 (N.D. Ga. 1967).

In order to find out what insurance activities were "closely related," if any, and to determine whether net public benefits would result from entry, IIAA sought a formal hearing on insurance agency applications submitted by various bank holding companies. In March 1973, the Board set 22 such cases for hearing and the war of attrition was on.

Ultimately, seven bank holding company insurance agency application cases were tried as test cases. The Administrative Law Judge essentially ruled in favor of the bank holding companies and the Board on the "closely related" issue, and against the bank holding companies on the public benefits test.¹⁷ On review, the Federal Reserve Board held almost uniformly for the bank holding companies on all issues. These matters are currently before the Fifth Circuit on appeal.

In light of the foregoing, therefore, it is clear that the regulatory system currently in effect favors the bank holding companies in view of the fact that interested nonbanking entities are required to expend immense resources in order to attempt to get the Board to undergo a careful examination of the full economic implications of bank holding company entry into nonbanking industries. In this connection, so far, IIAA has had to go to the courts on *four* separate occasions.

ANALYSIS OF THE LEGISLATION

As stated previously, S.2721 is a step in the right direction toward meaningful bank holding company reform. With the inclusion of the amendments we propose, S.2721 would be more strongly pro-consumer by protecting competition in various nonbanking industries and also more pro-banking by helping assure the continued soundness of our banking system.¹⁸

However, in a number of important ways the provisions of S.2721 would help clarify and strengthen the current law restricting bank holding companies from engaging in nonbanking activities. Section 2, for example, calls particular attention to the increased concentration of banking resources into the hands of a few large organizations, and to the fact that the Federal Reserve Board has permitted bank holding companies to extend the areas of nonbanking activities in which bank holding companies may participate far beyond those which are directly related to banking.¹⁹ As indicated previously, the recent growth of the size and diversity of banking institutions has been significant. In addition, the troubles which currently afflict major banking institutions points up the precariousness in which nonbanking activities have placed many important banking organizations.

Sections 101, 102, 201 and 202 would amend the Federal antitrust and related laws to provide more stringent standards for bank mergers and bank holding company acquisitions. Again, in light of the recent dramatic growth and increased concentration of economic power in large banking institutions, and restrictions set forth in the referenced sections would help contribute to a more competitive atmosphere in the banking industry in the future.

Section 301 would amend the existing bank holding company law to limit the kinds of activities in which bank holding companies may participate to those which are closely and directly related to banking. In addition, such activities would be permitted to be pursued only where bank holding company participation in the activities would be likely to produce substantial benefits to the public. For the reasons previously stated, the power of banking organizations over credit is such that to permit them to participate in activities which are not very closely and specifically related to banking is to invite economic preemption by banking organizations of industries with respect to which the public interest would be better served if the banks were kept out. In this connection, while the language of this provision of S.2721 brings increased clarity to the current law, it still permits the Federal Reserve Board some latitude of interpretation within which to circumvent the intent of Congress. Given the high degree of sympathy which administrative agencies often feel toward their constituents, in any adjudicatory proceeding before the Federal Reserve Board between a bank holding company making application to engage in a nonbanking activity, and nonbanking intervenors seeking to oppose the application, the

¹⁷ See, e.g., Appendix 10, at p. 71.

¹⁸ See Appendix 1, at p. 33.

¹⁹ A description of the lines of insurance and the circumstances under which such lines of insurance may be sold in accordance with Federal Reserve Board determinations is provided in Appendix 9, at p. 70.

nonbank parties are placed at a severe disadvantage. In addition, in any series of protracted adjudications between bank holding companies and groups of nonbanking entities opposing bank holding company entry into their industries, the war of attrition will almost certainly eventually be won by the bank holding companies, especially where there is a sympathetic regulator involved. This is particularly true in the face of the substantial evidence test under the current law since such test permits an agency to approve an activity as being in the public interest when the weight of the evidence would compel a different conclusion. It is for these reasons, that IIAA believes that ultimately the only solution to the bank holding company nonbanking problem is one that is made at the legislative level by defining specific activities in which bank holding companies may not engage.

Section 104 would prohibit banks from engaging in activities found by the Federal Reserve Board to be prohibited for bank holding companies. This provision would be very effective in preventing the type of forum shopping that results from the "competition in laxity" which has been recognized by Chairman Burns of the Federal Reserve Board. This provision, of course, points up the value of having the type of unified bank regulatory framework contemplated by S.2298, which the Chairman of this Committee introduced on September 5, 1975.

Section 501 would prohibit bank holding companies from discriminating in favor of their subsidiaries in making loans or establishing the terms and conditions of credit. This provision would help temper the effect of the tremendous economic power and ready availability of credit nonbanking affiliates of bank holding companies have with respect to the bank holding company parent and the banking subsidiaries of the holding company. Similarly, as discussed previously, it would ameliorate the potentially pernicious effects of having a bank holding company commercial bank bail out an ailing nonbanking affiliate to the detriment of the bank.

Section 601 would require the Federal Reserve Board to adopt more stringent administrative and judicial-like procedures in deciding what constitutes permissible activities for bank holding companies. Such procedures are essential to assure that the intent of the statute is at all times applied in the context of record evidence which is subject to review by courts on appeal. In this connection, as stated previously, IIAA has on a number of occasions found it necessary to initiate litigation in order to prevent the Federal Reserve Board from promulgating regulations without following the procedures laid down in the current law.²⁰

Section 701 would provide interested persons and organizations with the opportunity to petition the Federal Reserve Board to consider altering orders and regulations relating to bank holding company participation in nonbanking activities. This provision is immensely important in view of the fact that the circumstances under which the Board might determine that the participation by a bank holding company in a nonbanking activity is in the public benefit may change. In circumstances where material change does occur, the section would provide a mechanism by which the public interest can be policed on an on-going basis.

Because of the tremendous importance of the issues presented by S.2721, and in light of the experience IIAA has had with respect to the current law, IIAA urges that the Congress adopt legislation which specifically prohibits bank holding company participation in certain activities. In that connection, as provided in S.2721, IIAA would amend the existing bank holding company law to limit the kinds of activities in which bank holding companies may participate to those which are closely and directly related to banking and only under circumstances where bank holding company participation in the activities would be likely to produce substantial benefits to the public. In addition, unlike S.2721, IIAA urges a provision which would list certain activities which would be prohibited to bank holding companies. The benefit of specific prohibitions is that they serve to define the limits of banking organization power and they help avoid circumvention by regulatory agencies. It seems to us that the ability of banking organizations to tie the provision of nonbanking services to exten-

²⁰ See pp. 40, *supra*.

sions of credit is clear. For this reason, it seems to us that specific prohibition is the preferred approach.²¹

CONCLUSION

Legislative reform of bank regulatory problems is needed immediately since, as stated previously, in the battle of attrition being waged by banking organizations with respect to a number of nonbanking activities (including the sale of property and casualty insurance), nonbanking entities ultimately cannot expect to prevail. For this reason, Congress must act promptly. S. 2721 represents movement in the right direction. However, IIAA believes that S. 2721 should be amended to include specific legislative prohibitions against bank holding company participation in specified nonbanking activities.

Appendix 1

SECTION-BY-SECTION ANALYSIS OF ALTERNATIVE TO S. 2721

Short title establishes as the short title the "Competition in Banking Act of 1975."

Section 2 contains a statement of Congressional findings more detailed than that contained in S. 2721. The findings highlight certain important statistics and outline carefully the many reasons why bank and bank holding company reform is necessary at this time.

Section 201, 202, 301 and 302 would amend Federal antitrust and related laws to provide more stringent standards for bank mergers and bank holding company acquisitions. Under the proposed legislation, mergers and acquisitions would be prohibited where the resultant banking institution will control more than 20% of the bank assets in any one state. The effect of this provision will be to limit the growth of "banking giants" and thereby contribute to a more competitive atmosphere in the banking industry and between banks and those who compete with banks in providing financially related services to the public.

Section 401 would amend existing bank holding company law to limit the kinds of activities in which bank holding companies may participate. Under the proposed law, holding companies would be permitted to engage only in those activities which are very closely and directly related to banking and only under circumstances where bank holding company participation in the activities is likely to produce substantial benefits to the public. In addition, unlike S. 2721, this provision of the alternative bill would include a list of certain activities which would be prohibited to bank holding companies. The list, sometimes called a "negative laundry list," is identical to the one passed by the House of Representatives in 1969 as part of the Bank Holding Company Act Amendments of 1970. The effect of this provision will be to limit bank holding company entry into nonbanking activities which are not by their nature directly related to banking.

Section 501 would prohibit national banks from engaging in activities found by the Federal Reserve Board to be prohibited to bank holding companies. The effect of this provision is to make more uniform and consistent, as between banks and their bank holding company cousins, the scope of permissible banking activity.

Section 601 would prohibit bank holding companies from discriminating in favor of their subsidiaries in the making of loans or establishing the terms and conditions of credit. The effect of this provision is to eliminate much of the financial advantage and competitive edge which flows to a subsidiary of a bank holding company vis-a-vis its nonbank related competitors.

Section 701 would require the Federal Reserve Board to adopt more stringent administrative and judicial-like procedures in deciding what constitutes permissible activities for bank holding companies. The effect of this provision will be to give greater procedural safeguards to persons who challenge, before the Federal Reserve Board, bank holding company entry into nonbanking activities.

²¹ See Appendix 1.

Section 801 would provide interested persons and organizations with the opportunity to petition the Federal Reserve Board to consider altering orders and regulations relating to bank holding company participation in nonbanking activities. The effect of this provision will be to give to interested persons the opportunity to petition the Federal Reserve Board to halt the activities of bank holding companies (or of a particular holding company) which engage in improper activities.

Section 901 establishes an effective date for the legislation 90 days following the date of its enactment.

PROPOSED ALTERNATIVE TO S. 2721

A BILL To amend the Bank Holding Company Act and the Bank Merger Act to restrict the activities in which registered bank holding companies may engage and to control the acquisition of banks by bank holding companies and other banks.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Competition in Banking Act of 1975".

TITLE I—CONGRESSIONAL FINDINGS

SEC. 101. The Congress makes the following findings:

(A) In recent years bank mergers and consolidations have increased significantly in number and resulted in unbridled growth in the concentration of economic and financial resources in the hands of banking institutions. The Congress further finds that, under existing law, neither the bank regulatory agencies nor the courts have adequately limited merger activity to protect the needs of the public. Consequently, the Congress finds it necessary to clarify and strengthen the statutory standards governing bank mergers.

(B) It is necessary, because of a significant number of developments in recent years, to clarify and strengthen the traditionally stated Congressional intent to maintain a clear separation of commercial banking from other business activity in order to preserve and encourage an independent and competitive economic system. Among the most important recent developments that have occurred is the significant threat to the continuing existence of many small independent businesses posed by large financially powerful banking institutions moving into nonbanking businesses.

(C) Since the passage of the 1970 amendments to the Bank Holding Company Act of 1956, statutory standards as to what are permissible nonbank activities for banking institutions have been poorly interpreted. In the main, statutory standards governing permissible nonbank activities have not been interpreted as narrowly as was the Congressional intent under existing legislation. The Federal Reserve Board, for example, has not sufficiently limited or halted bank holding companies from engaging in the general business of (1) performing the functions of an insurance agency, (2) performing the functions of an insurance underwriter, (3) providing automobile and other leasing services, (4) performing the functions of a travel agency, (5) providing auditing or other professional services in the field of accounting, (6) providing courier services, (7) providing management consulting services, (8) providing data processing services, or (9) selling stocks, bonds, or other similar securities, or interests in any such securities. The entry of large and powerful banking institutions in a number of industries which are characterized by numerous, small, and vigorously competitive economic entities is having long range anticompetitive effects with no significant offsetting benefits to the public. Moreover, the industries affected are among the few still affording opportunity to individuals who are without substantial personal assets but who wish to own and operate their own businesses. Consequently, it is necessary for the Congress to further refine the line between banking and commerce and clarify the definition of activities that are permissible for banking institutions to engage in.

(D) There has been explosive growth of bank holding companies, as well as nonbank activities of bank holding companies, since passage of the 1970 amendments to the Bank Holding Company Act. In the four years between

1970 and 1974, bank holding companies increased their control of all commercial bank deposits in the United States from 52.6 percent to 68.1 percent. Bank holding company acquisitions of existing banks as of the end of 1973 accounted for 73 percent of all bank acquisitions. Bank holding company acquisitions of nonbank firms also grew dramatically during the last few years. The number of such acquisitions in 1970 was 6, in 1973 it was 827, and in 1974 it was 806. In addition, de novo entry into nonbank activities climbed from 71 in 1971 to 542 in 1974.

(E) One adverse consequence of significant bank expansion into nonbanking activities is the change in bank management philosophy and attitude from that of conservative banking practices to the more aggressive risk-taking approach of the business entrepreneur. This new management attitude toward the use of depositors' money raises serious long-range problems for the safety, soundness and ability of the banking system to serve adequately the financial needs of the economy and the public.

(F) Because of the often far-reaching interpretations of permissible nonbanking activities, the federal bank regulatory agencies have overextended themselves to the extent that they are unable to adequately evaluate the risks to individual banking institutions or to the banking system in general created by the rapid and broad expansion of banking institutions into a wide variety of nonbanking activities. Consequently, these agencies are unable under present circumstances to adequately protect bank depositors or the public from unsafe and unsound banking practices and to see that the economy in general is supported by a strong banking system.

(G) Experience with interpreting and enforcing the banking laws in the area of permissible nonbanking activities over the past several years has raised serious questions as to the adequacy of administrative procedures to protect the legitimate interests of the public and of parties who are potentially seriously adversely affected by regulatory rulemaking and adjudicatory proceedings. Consequently, Congress finds it necessary to provide for more complete administrative procedures to adequately protect these interests.

(H) There has emerged inconsistent rulings between different federal bank regulatory agencies dealing with the disposition of cases concerning the same nonbank activities. Interested parties appearing before different federal regulatory agencies have been treated both procedurally and substantively in entirely different manners, clearly not affording them fair treatment consistent with due process of law.

(I) There is a need for more adequate surveillance of the ongoing nonbank activities of bank holding companies to ensure that those activities continue to conform to the standards for permissible activity established by the regulatory agencies and the courts. In addition, there is need to make available to the public a more complete procedure under which interested persons may call to the attention of regulatory agencies errant nonbank activity on the part of bank holding companies.

(J) Banks occupy a unique position in the United States economy. They have been granted by the government a monopoly franchise in return for assumption of the responsibility to carry out the indispensable function of providing adequate capital on a fair and equitable basis to business enterprises and individuals. Affiliation of nonbank enterprises with banking institutions gives to such nonbank enterprises in many instances an unfair competitive advantage in the access to and cost of obtaining capital and credit. Consequently, the substantial movement of banking institutions into nonbanking activities raises serious questions of unfair advantage, unfair competition with bank depositors and borrowers, and conflicts of interest and concentration of economic power.

(K) The ability to tie the provision of one type of service to that of another is especially prevalent in the banking industry. When tying does occur, the effect is to decrease significantly competition and to thereby detrimentally affect consumer options. Tying can occur by overt act or subtle pressure, or as a result of the mere juxtaposition of a dear commodity like bank credit with other consumer products. The more nonbanking activities banking institutions are permitted to engage in, the more the opportunity for tying, particularly in light of the concentration of lending power in banking institutions.

TITLE II—STANDARDS FOR BANK MERGERS

SEC. 201. Paragraph (5) of section 18(c) of the Federal Deposit Insurance Act is amended to read as follows:

"(5) The responsible agency shall not approve—

"(A) any proposed merger transaction which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States, or

"(B) any other proposed merger transaction whose effect in any section of the country may be substantially to lessen competition, or to tend to would be in restraint of trade, unless it finds that the anticompetitive effects of the proposed transaction are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served, or

"(C) any other proposed merger transaction if, either as a result of such merger transaction or because of its preexisting assets, the acquiring, assuming, or resulting bank would upon consummation of transaction hold more than 20 per centum of the total assets held by all banks located in the State in which such bank is located: Provided, however, that this subparagraph shall not apply to any merger or consolidation of banks in which the responsible agency finds that immediate action is necessary to prevent the probable failure of a bank and that a less anticompetitive alternative is not available.

"For purposes of this paragraph, if any company has, or upon consummation of the merger transaction would have, control, as defined in section 2 of the Bank Holding Company Act of 1956, over the acquiring, assuming, or resulting bank, total assets held by all banks over which the same company has such control shall be attributed to such bank. As used in this paragraph, the terms 'bank' and 'company' have the meaning ascribed to such terms in section 2 of the Bank Holding Company of 1956. In every case, the responsible agency shall take into consideration the financial and managerial resources and future prospects of the existing and proposed institutions, and the convenience and needs of the community to be served. Nothing contained in this paragraph or in any other paragraph of this subsection shall prevent the responsible agency from disapproving any other merger transaction on the grounds that such transaction would have adverse effect on competition or concentration in any market, region, State, or other area which, although not requiring disapproval under subparagraph (A), (B) or (C) of this paragraph, are not clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served."

SEC. 202. Section 18(c) of the Federal Deposit Insurance Act is amended by inserting in paragraph (8) after "(the Clayton Act," the words "paragraph (9) of this subsection, and"; and by renumbering section "(9)" and "10"; and by adding a new paragraph "(9)" as follows:

"(9) (A) Every merger transaction having the effects set forth in subparagraph (C) of paragraph (5) of this subparagraph is declared to be illegal.

"(B) The district courts of the United States have jurisdiction to prevent and restrain violations of subparagraph (A) of this paragraph, and it is the duty of the United States attorneys, under the direction of the Attorney General, to institute proceedings in equity to prevent and restrain such violations. The proceedings may be by way of a petition setting forth the case and praying that the violation be enjoined or otherwise prohibited. When the parties complained of have been duly notified of the petition, the court shall proceed, as soon as possible, to the hearing and determination of the case. While the petition is pending, and before final decree, the court may be any time make such temporary restraining order or prohibition as it deems just. Whenever it appears to the court that the ends of justice require that other parties be brought before it, the court may cause them to be summoned whether or not they reside in the district in which the court is held, and subpoenas to that end may be served in any district by the marshal thereof.

"(C) In any action brought by or on behalf of the United States under subparagraph (A) of this paragraph, subpoenas for witnesses may run into any district, but no writ of subpoena may issue for witnesses living out of the district in which the court is held at a greater distance than one hundred miles from the place of holding the same without the prior permission of the trial court upon proper application and cause shown.

"(D) Nothing contained in this paragraph shall be construed as affecting in any manner the right of the United States or any other party to bring an action under any other law of the United States or of any State, including any right which may exist in addition to specific statutory authority, challenging the legality of any merger transaction which may be proscribed by this paragraph."

TITLE III—STANDARDS FOR BANK HOLDING COMPANY ACQUISITIONS OF BANKS

SEC. 301. Paragraph (c) of section 3 of the Bank Holding Company Act of 1956 is amended to read as follows:

"(c) The Board shall not approve—

"(1) any acquisition or merger or consolidation under this section which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States, or

"(2) any other proposed acquisition or merger or consolidation under this section whose effect in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade, unless it finds that the anti-competitive effects of the proposed transaction are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served, or

"(3) any other proposed acquisition, merger, or consolidation transaction under this section if, either as a result of such transaction or because of the preexisting bank assets over which it has control, the acquiring or resulting company would have control over aggregate total banking assets held by all banks and bank holding companies located in the State in which such company is located: *Provided, however,* that this paragraph shall not apply to any acquisition, merger, or consolidation transaction in which the Board finds that immediate action is necessary to prevent the probable failure of a bank and that a less anticompetitive alternative is not available.

"In every case, the Board shall take into consideration the financial and managerial resources and future prospects of the company or companies and the banks concerned, and the convenience and needs of the community to be served. Nothing contained in this chapter shall prevent the Board from disapproving any other acquisition, merger, or consolidation transaction on the grounds that such transaction would have adverse effects on competition or concentration in any market, region, State, or other area which, although not requiring disapproval under paragraph (1), (2), or (3) of this subsection, are not clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served."

SEC. 302. The Bank Holding Company Act of 1956 is amended by inserting in section 1849(f) after "(the Clayton Act," the words "subsection (g) of this section"; and by adding to section 1849 a new section (g) as follows:

"(g) (1) Every acquisition, merger, or consolidation transaction having the effects set forth in paragraph (3) of subsection (c) of section 3 of this chapter is declared to be illegal.

"(2) The district courts of the United States have jurisdiction to prevent and restrain violations of paragraph (1) of this subsection, and it is the duty of the United States attorneys, under the direction of the Attorney General, to institute proceeding in equality to prevent and restrain such violations. The proceedings may be by way of a petition setting forth the case and praying that the violation be enjoined or otherwise prohibited. When the parties complained of have been duly notified of the petition, the court shall proceed, as soon as possible, to the hearing and determination of the case. While

the petition is pending, and before final decree, the court may at any time make such temporary restraining order or prohibition as it deems just. Whenever it appears to the court that the ends of justice require that other parties be brought before it, the court may cause them to be summoned whether or not they reside in the district in which the court is held, and subpoenas to that end may be served in any district by the marshal thereof.

"(3) In any action brought by or on behalf of the United States under paragraph (1) of this subsection, subpoenas for witnesses may run into any district, but no writ of subpoena may issue for witnesses living out of the district in which the court is held at a greater distance than one hundred miles from the place of holding the same without the prior permission of the trial court upon proper application and cause shown.

"(4) Nothing contained in this subsection shall be construed as affecting in any manner the right of the United States or any other party to bring an action under any other law of the United States or of any state, including any right which may exist in addition to specific statutory authority, challenging the legality of any acquisition, merger, or consolidation transaction which may be proscribed by this subsection."

TITLE IV—STANDARDS FOR BANK HOLDING COMPANY ENTRY INTO BANK RELATED ACTIVITIES

SEC. 401. (a) Section 4 (c) (8) of the Bank Holding Company Act of 1956 is amended to read as follows:

"(8) (A) subject to the provisions of subparagraph (B), shares of any company the activities of which the Bank, on the record and after due notice and opportunity for hearing, has determined (by order or regulation)—

(1) to be so closely and directly related to banking or managing or controlling banks as to be a necessary and proper incident thereto, and

(2) is likely to produce substantial benefits to the public which clearly and significantly outweigh possible adverse effects. For the purposes of this subparagraph, (a) the term "substantial benefits to the public" includes increased competition over the course of time and greater convenience or gains in efficiency of operation that will substantially benefit the public, and (b) the term "adverse effects" includes undue concentration of economic or financial resources, decreased competition over the course of time, unfair competition, conflicts of interest, unsafe or unsound banking or business practices, risk to the financial soundness of a bank holding company or its banking subsidiaries, and interference with the primary responsibility of a bank holding company or its banking subsidiary to provide effective banking services to the public. For the purposes of determining in specific cases whether the performance of a particular activity by an affiliate of a bank holding company is likely to produce substantial benefits to the public which clearly and significantly outweigh possible adverse effects, the Board, in addition to its other considerations, shall take into consideration (i) the relative economic size and market power of the bank holding company and that of those with whom the affiliate would compete, and (ii) whether or not such benefits satisfy a need on the part of the public which cannot reasonably be expected to be met by other means.

(B) For the purposes of subparagraph (A), the following activities are not so closely and directly related to banking or managing or controlling banks as to be a necessary and proper incident thereto:

"(1) Engaging in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, or of interests in any such securities, whether or not the securities to which any such interests relate are in a fund or account or are subject to discretionary sale or purchase, except in the case of—

"(A) the issuance by any bank of certificates of deposit, passbooks, acceptances, checks, or other evidences of banking liabilities;

"(B) the issuance by any bank, bank holding company, or subsidiary thereof of stock, bonds, notes, or other evidences of capital loaned to or invested in the bank, company, or subsidiary itself and not in any fund or account for reinvestment; and

"(C) dealing in and underwriting securities which are by the terms of paragraph 'Seventh' of section 5136 of the Revised Statutes exempted from the limitations and restrictions contained in that paragraph as to dealing in and underwriting investment securities.

"(2) Providing insurance either as principal or as agent, except (A) where the insurance is limited to insuring the life of a debtor pursuant to or in connection with a specific credit transaction, or providing indemnity for payments coming due on a specific loan or other credit transaction while the debtor is disabled, or (B) in the case of a national bank, to the extent permitted by the eleventh paragraph of section 13 of the Federal Reserve Act, and in the case of any other bank, to the extent permitted under the laws of the jurisdiction under which it is organized and doing business.

"(3) Engaging in business as a travel agency.

"(4) Engaging in the business of providing auditing or other professional services in the field of accounting.

"(5) Engaging in the business of providing data processing services except—

"(A) as an incident to banking services such as the preparation of payrolls, or

"(B) to the extent necessary to make economical use of equipment primarily acquired and used for the bank holding company or its bank subsidiaries.

"(6) Engaging in the business of leasing property except under arrangements whereby the lessee is—

"(A) obligated to pay over the term of the lease not less than the entire cost of the property, and

"(B) entitled to ownership of the property at the end of the term of the lease either for a nominal consideration or for no consideration."

(b) (1) Notwithstanding the provisions of subsection (a), and subject to the provisions of subparagraph (2) of this subsection, a bank holding company may continue to engage in those activities in which it directly or through a subsidiary (A) was lawfully engaged on November 1, 1975 (or on a date subsequent thereto in the case of activities carried on as a result of the acquisition by such bank holding company or subsidiary thereof, pursuant to a binding written contract entered into on or before November 1, 1975, of another company engaged in such activities at the time of the acquisition), and (B) has been continuously engaged since November 1, 1975 (or such subsequent date), except that such a bank holding company shall not permit the scope or size (in terms of volume of business) of those activities to expand to any significant degree.

(2) The Federal Reserve Board by order, after opportunity for hearing, may terminate the authority conferred by subparagraph (1) on any bank holding company to engage directly or through a subsidiary in any activity otherwise permitted by subparagraph (1) if the Board determines, having due regard for the purposes of this Act, that such action is necessary to prevent undue concentration of economic or financial resources, decreased competition over the course of time, unfair competition, conflicts of interest, unsafe or unsound banking or business practices, risk to the financial soundness of a bank holding company or its banking subsidiaries, or interference with the primary responsibility of a bank holding company or its banking subsidiary to provide effective banking services to the public.

TITLE V—UNIFORM APPLICATION OF STANDARDS GOVERNING ENTRY INTO BANK RELATED FIELDS

Sec. 501. (a) Subject to the provisions of subsection (b), no national bank shall directly or through a subsidiary engage in any activity which is found—

(1) pursuant to a regulation of the Federal Reserve Board issued after the effective date of this Act to be an improper activity for bank holding companies under section 4(c) (8) of the Bank Holding Company Act of 1956, or

(2) pursuant to an order of the Federal Reserve Board issued after the effective date of this Act to be an improper activity for the bank holding company of which such national bank is a subsidiary.

(b) Nothing contained in this section shall be interpreted or construed as authorizing a national bank to engage in any activity prohibited to it under any other provision of law.

TITLE VI—STANDARDS FOR SOUND AND COMPETITIVE FINANCING OF NONBANKING ACTIVITIES

SEC. 601. (a) Section 4 of the Bank Holding Company Act of 1956 is amended by inserting at the end thereof the following new subsection:

“(f) In keeping with its responsibilities to administer and carry out the purposes of this Act, and with particular attention to the standards established under subparagraph (8) of subsection (c) of this section, the Board shall require, both in connection with a bank holding company application to engage in a particular activity and in connection with the Board’s ongoing supervision of bank holding companies, that (1) bank holding companies and their subsidiaries be capitalized and otherwise financed in a safe and sound manner, and (2) bank subsidiaries of bank holding companies refrain from discriminating in favor of their parent holding company or their affiliated subsidiaries in the making of loans or in the establishing of terms and conditions of credit.

(b) Subsection (c) of section 5 of the Bank Holding Company Act of 1956 is amended by striking out “(c)” and inserting in lieu thereof “(c) (1)” and by inserting at the end of such subsection the following new subparagraph:

“(2) In addition to such other reports as the Board may from time to time require, the Board shall require each bank holding company to submit to the Board each year a report detailing the terms and conditions of all inter-company loans and investments, as between the bank holding company and its subsidiaries and as between any such subsidiaries, made during the twelve-month period immediately preceding such report. The Board shall make such reports available to the public.”

TITLE VII—ADMINISTRATIVE PROCEDURES AND JUDICIAL REVIEW

SEC. 701. (a) The Bank Holding Company Act of 1956 is amended by redesignating sections 9, 10, 11, and 12 as sections 10, 11, 12, and 13, respectively, and by inserting immediately after section 8 the following new section:

“Sec. 9. (a) The provisions of sub chapter II of chapter 5 of title 5 of the United States Code (relating to administrative procedure) shall apply with respect to all Board proceedings under section 4(c) (8).

“(b) All Board determinations (whether by order or regulation) under section 4(c) (8) shall be made on the record after opportunity for hearing, and the provisions of sections 556 and 557 of title 5 of the United States Code shall apply with respect thereto. The Board shall give all interested persons an opportunity to participate in any such hearing. All such orders and regulations shall be accompanied by a detailed statement of findings and conclusions, and the reasons or basis therefor, on all the material issues of fact, law, or discretion, presented on the record relating to such orders and regulations.

“(c) (1) In connection with any proceeding under section 4(c) (8), no person shall, directly or indirectly, make or attempt to make any ex parte presentation in connection with the subject matter of any such proceeding to any member of the Board or any member of the Board staff participating in such proceeding.

“(2) No application made under section 4(c) (8) shall be held or considered to be an application for an initial license within the meaning of subsection (d) of section 554 of title 5 of the United States Code.

“(d) In connection with any proceeding under section 4(c) (8) to which the requirements of sections 556 and 557 of title 5 of the United States Code are being applied, any interested person participating in such proceeding may call upon (1) the Board, or, (2) in the case of the consideration of an application, the applicant, for any information or documents, not privileged, for purposes of discovery or for use as evidence. In addition, in any such proceeding where there is an absence of relevant information, the

Board, upon its own motion or that of any interested person participating in such proceeding, shall undertake such studies (and make reports thereon available) as will provide the relevant information required."

(b) Section 9 of the Bank Holding Company Act of 1956 (as in effect immediately prior to the enactment of this Act) is amended (1) by inserting "or regulation" immediately after "order" each place it appears, and (2) by striking out "as provided in section 2112 of title 28, United States Code" and inserting in lieu thereof the following: "in the same manner as provided in section 2112 of title 28, United States Code, with respect to orders of administrative agencies".

TITLE VIII—PUBLIC'S RIGHT TO PETITION FOR MODIFICATION OF ORDERS AND REGULATIONS

SEC. 801. The Bank Holding Company Act of 1956 (as amended by section 501 of this Act) is further amended by inserting at the end of the new section 9 thereof the following new subsection:

"(c) (1) Any interested person, including a consumer or consumer organization, may petition the Board to commence a proceeding to consider the issuance, amendment, or revocation of an order or regulation promulgated under the authority of section 4(c) (8). Such petition shall set forth (a) facts which it claimed established that the issuance, amendment, or revocation of an order or regulation is necessary, and (b) a description of the substance of the amendment or of the order or regulation it is claimed should be issued, as the case may be.

"(2) The Board may conduct a public hearing or may conduct such investigation or proceeding as it deems appropriate in order to determine whether or not such petition should be granted. Facts which warrant the issuance, amendment, or revocation of an order or regulation shall include, in addition to such other matters as the Board may from time to time determine to be appropriate, the following matters:

"(A) a finding that particular activity conducted on the part of a bank holding company or its subsidiary fails to conform to the scope of the activity for which Board approval was originally given;

"(B) a finding that a particular activity conducted on the part of a bank holding company or its subsidiary fails to conform to new or amended Board orders or regulations or judicial determinations altering the scope of the activity for which Board approval was originally given;

"(C) a finding that the continued conduct of a particular activity on the part of a bank holding company or its subsidiary has ceased to produce, within the meaning of section 4(c) (8), substantial benefits to the public which clearly and significantly outweigh possible adverse effects; or

"(D) a finding that the continued conduct of a particular activity on the part of a bank holding company or its subsidiary otherwise violates the standards established under section 4(c) (8) for permissible bank holding company activity.

"(3) Within one hundred and twenty days after filing of a petition referred to in subparagraph (1), the Board shall either grant or deny the petition. If the Board grants such petition, it shall promptly proceed to determine, on the record and after opportunity for hearing, whether to issue, amend, or revoke such order or regulation. If the Board denies such petition, it shall publish in the Federal Register its reasons for such denial.

"(4) If the Board denies such petition, or if the Board fails to grant or deny such petition within one hundred and twenty days after the filing of the petition, the petitioner may commence a civil action in a United States district court to compel the Board to grant such petition. Any such action shall be filed within sixty days after the Board's denial of the petition, or, if the Board fails to grant or deny the petition within one hundred and twenty days after the filing of the petition, within sixty days after the expiration of the one hundred and twenty day period. If the petitioner can demonstrate to the satisfaction of the court, by a preponderance of evidence in a *de novo* proceeding before such court, that sufficient facts exist to justify the granting of the petition, the court shall order the Board to grant such petition.

"(5) In any action under this subsection, the district court shall have no authority to compel the Board to take any action other than to grant such a petition."

TITLE IX—EFFECTIVE DATE

SEC. 901. The Act and the amendments made by this Act shall take effect upon the expiration of ninety days following the date of enactment of this Act.

Appendix 2

A SYNOPSIS OF THE SOURCES OF BANK HOLDING COMPANY POWER IN THE SALE OF NONBANKING SERVICES

By Thomas Havrilesky, Duke University

THE BANKING MARKET

Commercial banks are granted by government an exclusive power to do a checking account business. Many other depository services that are sold by banks are direct complements to its checking account business. These include collection, payroll, lock box and other services.

Through legal restrictions on chartering and branching, government limits entry into the business of banking. This directly restrains competition to offer the above services.¹ Thereby, it directly inhibits competition for deposit funds. In addition, through legal prohibition of the payment of interest on checking account balances as well as through legal ceilings on the payments of interest on savings and time deposit account balances, government further limits competition for deposit funds.² Therefore a large portion of the funds obtained by commercial banks are obtained at a cost less than that which would be paid if these restrictions did not exist.

Various forms of government subsidy further reduce the cost of deposit and nondeposit funds to the bank. First, insured creditors (depositors) know that if their bank should fail the Federal Deposit Insurance Corporation (FDIC) either will have the liability for their deposit assumed by another bank or will pay them off directly. Therefore, insured creditors have not typically required a high return (in the form of below-cost charges on checking account services, interest and promotional rewards on savings and time deposits, and other services) on their funds. Second, the FDIC does not adjust deposit insurance premiums to reflect individual bank risk. Therefore, bank management can seek a high return on its loans and investments with less regard to the risk involved than it would obtain if deposit insurance were adjusted to reflect individual bank risk. Third, noninsured creditors typically have believed that the Office of the Comptroller of the Currency, the Federal Reserve and the FDIC will try to help a distressed bank recover and, if necessary, the Federal Reserve will make below-market loans to the distressed bank. Therefore, they also have typically not required a high interest return on their funds. Fourth, bank stockholders, like bank creditors, have not required a high return on their equity because they too expect to bear little of the risk assumed by management.

Now if risk-taking by bank management is not completely reflected in the costs of the funds it obtains, who bears the cost? The answer is that the (remaining) costs of bank risk-taking are borne by the U.S. taxpayer. This occurs in several ways. First, the Federal Reserve System, the Office of the Comptroller of the Currency and state banking agencies play key roles in the supervision, guidance and protection of banks, as well as in the rescue of distressed banks. These agencies are essentially taxpayer financed. Second, even though FDIC operations are financed by proceeds from insurance

¹ This is reflected in the concentration of the banking market, especially in metropolitan areas. For example, over 90 percent of the deposits in statewide branching states are in metropolitan markets where the three largest banks account for 60 percent or more of the deposits.

² The *Report of the President's Commission on Financial Structure and Regulation* (Washington, 1971) and other more recent studies emphasize that regulatory differentials inhibit competition among depository institutions.

premium paid by banks, the FDIC is not taxed as would be a private insurer. Moreover, the FDIC receives a good deal of information and could not do its job at current premium levels, without support from the other, taxpayer-financed, agencies.

There are other forms of subsidy that should not be lightly regarded. The Federal Reserve will collect, free of charge, all checks that any member banks want to deposit or checks from nonmember banks in its district; it will lend money to member banks; it will assume all the risk and cost of disbursing currency to member banks; it will handle noncash deposits of member banks; it will wire money from a member bank account to any bank in the country, free of charge, except for transfers within a Reserve district; and it will provide for the safekeeping and buying and selling of government securities. The total operating costs of the Federal Reserve System last year were approximately \$600 million.

On the other hand, some argue that this subsidy is overshadowed by the fact that member banks receive no interest on the balances they maintain at Federal Reserve Banks. Given today's short-term market rates of interest, member banks could be earning approximately one billion per year on these balances at a rate of interest commensurate with their liquidity and safety.

Nevertheless, it can be contended that the failure to pay interest on reserves represents an (inefficient) "tax" on the monopoly franchise granted to banks to do a banking business. The tax is "fair" because banks, unlike other untaxed monopolists such as patent holders, have done nothing to entitle them to a monopoly position. Indeed, if the franchise to do a checking account business were freely available to all, banking's excess profits would disappear.³

Despite the inefficiency and fairness of the tax, the financial market's typical regard of the stocks of commercial banks suggests that its level has not been high enough to erode banking's supernormal profits. Moreover, rough calculations indicate that the combined current operating budgets of the Federal Reserve, the Office of the Comptroller of the Currency and the fifty state banking authorities far exceed the interest income foregone on reserves because of this tax. Thus, the net governmental subsidy to the banking system is still rather sizable.

Because of their cost advantage at attracting funds, commercial banks can make many types of loans on lower terms than other financial intermediaries.⁴ Because they have cost advantages in lending and have been granted unique depository powers, the commercial banks' product consists of a *package* of depository and lending services. For certain types of depository services (e.g., services related to having a checking account) and for certain types of loans (e.g., smaller, short-term, commercial loans) both parts of the banking product have been traditionally isolated from any competition. In other areas banks link the sale of their unique depository services⁵ to the sale of low cost lending services so that their product cannot be easily duplicated by other financial intermediaries. For example, commercial banks encourage deposit retention through favorable accommodation of the credit demands of, as well as the provision of other services to, long-term depositors. These credit demands are not just short-term commercial loan demands;⁶ they include, for example, the credit demands of local governments. As another example, in order to be able to accommodate the loan demands of longterm depositors, in the past fifteen years banks have

³ There is, of course, no sound reason to argue that banking should not be a purely competitive industry. If it were, there would be no basis for bank entry into other industries. It should be kept in mind that the production of money has been a source of revenue for government since the dawn of recorded history.

⁴ The recent history of judicial interpretations of the product market in banking supports this argument. For example, the Supreme Court states that since banks can obtain funds more cheaply, they lend at lower rates. *United States vs. Philadelphia National Bank*, et. al., 210 Supp. 348 (1962); 83 S.Ct. 1715 (1963).

⁵ In the *United States vs. First National Bank and Trust Company of Lexington*, et. al., 208 Supp. 457 (1962); 84 S.Ct. 1033 (1964) the uniqueness of checking account, deposit box, correspondent bank and trust services were mentioned.

⁶ See, for example, Nell B. Murphy, *A Test of the Deposit Relationship Hypothesis*, Staff Study No. 38 (Washington, Board of Governors, 1970). See also Donald R. Hodgman, *Commercial Bank Loan and Investment Policy* (Champaign, University of Illinois Press, 1963).

managed their liabilities as well as their short-term assets. Yet another example of the strong complementarity between depository and lending services is the use of compensating balance requirements in lending agreements as a means of retaining deposits. Finally, the low cost of loans from a commercial bank is so desirable that very often not only checking account but numerous other services will be purchased by the customer in order to develop a good relationship with the banker.⁷ The notion of "full service banking" is strongly connotative of this complementarity.

BANK ENTRY INTO NONBANKING INDUSTRIES

Monopoly power generally will produce excess or supernormal profit. Commercial banks have unique powers in the provision of checking account and related services. Subsidy will also generate excess or supernormal profit. Banks receive services from government agencies which typically reduce the cost of their funds.

Now consider the use that can be made of the profits of a commercial bank that is part of a bank holding company. Profit can either be paid to stockholders of the holding company, taxed away by government, retained by the bank or retained by the holding company. Because of a significant number of tax shelters, bank profits are not heavily taxed. Federal income taxes paid by all insured banks in 1972 were only \$1.3 billion.⁸ Because bank holding company stockholders, as discussed earlier, do not expect to bear all the risk borne by the management of the lead bank, they do not typically require a high return on equity. Because of aforementioned legal restrictions on branching and mergers, the excess profits of the lead bank of a holding company are constrained *not* to be invested heavily in traditional banking areas. These leave a good share of supernormal banking profit to be retained by the parent of the holding company.

Retained earnings are then used to expand into nonbanking areas. Starting in 1971 bank holding companies moved aggressively into nonbanking activities. Bank holding companies now control 34 of the 100 largest mortgage banking firms, 27 of the 86 largest noncaptive finance companies and 13 of the 30 largest factoring companies. These affiliates were purchased outright or financed by equity issues.

Once acquired, these affiliates are financed by the parent of the bank holding company issuing debt. This is often done by leveraging beyond the standards of the nonbanking industry usually by the parent's borrowing directly or borrowing from the bank affiliate.⁹ Thus, bank holding companies are using the protected and government subsidized profit-generating ability of the lead bank to expand into nonbanking industries. The parent services this debt from the dividends paid by the lead bank.

Because the bank product consists of a package of available services and because price and branch locational competition are legally restricted, the quest to make available the services of nonbanking affiliates seems to have taken on the appearance of a competitive race. One motive for this race could be the acquisition of a wide geographic network of multipurpose offices which could produce benefits if Electronic Funds Transfer Systems and interstate branching are permitted. Another motive for expansion into nonbanking industries is profit.

CONCLUSION

The desire of bank holding companies to diversify their activities and geographical locations and to increase their profits through nonbanking affiliates provides the incentive for bank holding companies to attempt to enter nonbanking industries.

⁷ The advantage in terms of obtaining a low cost loan depends on purchasing a cluster of other services. This was considered in *United States vs. Phillipsburg National Bank and Trust Company, et al.*, 306 Supp. 645 (1969); 90 S.Ct. 2035 (1970).

⁸ It is estimated that if state and municipal obligations alone were taxable, the tax liability of all banks would rise by almost \$1.7 billion or 130 percent. See Margaret E. Bedford, "Income Taxation of Commercial Banks," *Monthly Review*, Federal Reserve Bank of Kansas City (July-August, 1975).

⁹ Samuel H. Talley, "Bank Holding Company Financing," *Conference on Structure and Competition* (Federal Reserve Bank of Chicago, 1975).

Furthermore, limited entry into banking markets, government supervision and subsidy of bank operations, and the ability of bank holding companies to provide thin capitalization to affiliated nonbanking entities, provides nonbanking subsidiaries of bank holding companies with a significant and multifaceted competitive advantage over similar nonbanking businesses which are not affiliated with bank holding company organizations.

APPENDIX 3.—Growth of Banks and Bank Holding Companies

Selected Statistical Materials

TABLE 1A—BANK HOLDING COMPANIES: 1972-74

Items	50 States and District of Columbia		Holding company groups as a percentage of all commercial banks
	Holding company groups	All commercial banks	
Banking Offices and Deposits of Banks in Holding Company Groups, Dec. 31, 1972			
Number of banking offices—totals:	16,161	38,325	42.1
Banks	2,720	13,927	-----
Branches	13,441	24,398	-----
Deposits (millions)	\$379,355	\$616,592	61.5
Assets (millions)	\$467,487	\$739,591	63.2

Source.—Federal Reserve Board Annual Report—1971 and Annual Report—1972, Board of Governors of the Federal Reserve System, Washington, D.C.

TABLE 1B—BANK HOLDING COMPANIES: 1972-74

Items	50 States and District of Columbia		Holding company groups as a percentage of all commercial banks
	Holding company groups	All commercial banks	
Banking Offices and Deposits of Banks in Holding Company Groups, Dec. 31, 1973			
Number of banking offices—totals:			
Banks	18,471	40,408	45.7
Branches	3,097	14,170	
	15,374	26,238	
Deposits (millions)	\$446,567	\$682,353	65.4
Assets (millions)	\$562,987	\$835,730	67.4

Source.—60 Federal Reserve Bulletin A83 (June 1974).

TABLE 1C—BANK HOLDING COMPANIES: 1972-74

Items	50 States and District of Columbia		Holding company groups as a percentage of all commercial banks
	Holding company groups	All commercial banks	
Banking Offices and Deposits of Banks in Holding Company Groups, Dec. 31, 1974			
Number of banking offices—totals:	20,593	42,761	48.2
Banks	3,462	14,465	-----
Branches	17,131	28,296	-----
Deposits (millions).....	\$509,737	\$748,341	68.1
Assets (millions).....	\$640,082	\$920,001	69.6

Source.—61 Federal Reserve Bulletin A79 (June 1975).

TABLE 2.—BANK HOLDING COMPANY GROUPS, DEC. 31, 1974

Multibank and 1-bank Holding Companies

Item	50 States and District of Columbia		Holding company groups as a percentage of all commercial banks
	Holding company groups	Commercial banks	
Number of banking offices—totals	20, 593	42, 761	48. 2
Banks	3, 462	14, 465	
Branches	17, 131	28, 296	R
Assets (millions)	\$640, 082	\$920, 001	69. 6
Deposits (millions)	\$509, 737	\$748, 341	68. 1

Note.—Companies listed include those that have reported to the Federal Reserve Board pursuant to the requirements of the Bank Holding Company Act and include some companies that have filed registration statements but whose holding company status has not yet been determined by the Board. (A list showing the names, total assets and total deposits of the subsidiary banks in the holding company groups is available upon request from the Board of Governors of the Federal Reserve System, Washington, D.C.)

TABLE 3.—BANK HOLDING COMPANY GROUPS, DEC. 31, 1974

Multibank and 1-bank Holding Companies

Classification	Companies	Number			Amount (millions)	
		Offices			Assets	Deposits
		Banks	Branches	Total		
Total	1, 752	3, 462	17, 131	20, 593	640, 082	509, 737
Member		1, 735	13, 830	15, 565	566, 963	447, 156
Nonmember		1, 727	3, 301	5, 028	73, 119	62, 581
Multibank	276	2, 122	8, 887	11, 009	358, 644	287, 381
Member		1, 223	7, 307	8, 530	321, 228	255, 254
Nonmember		899	1, 580	2, 479	37, 416	32, 127
1-bank	1, 340	1, 340	8, 244	9, 584	281, 438	222, 356
Member		512	6, 523	7, 035	245, 735	191, 902
Nonmember		828	1, 721	2, 549	35, 703	30, 454
All commercial banks		14, 465	28, 296	42, 761	920, 001	748, 341

Note.—Multi bank and 1-bank classifications are based on the number of banks controlled, directly or indirectly, by the top-tiered holding company. Holding companies that are subsidiaries of other holding companies are eliminated.

Source.—Federal Reserve Bulletin, June 1975, Board of Governors of the Federal Reserve System, Washington, D.C., p. A79.

TABLE 4.—BANK HOLDING COMPANIES IN 1974

Type of holding company	Number of companies	Number of banks	Number of branches	Percent of all commercial bank deposits
1 bank	1, 340	1, 340	8, 244	30
Multibank	276	2, 122	8, 887	38
Total	1, 616	3, 462	17, 131	68

Source: Federal Reserve Bulletin, June 1975, Board of Governors of the Federal Reserve System, Washington, D.C., p. A-79.

TABLE 5.—RELATIVE SIZE OF LARGEST BANK GROUPS IN SMSA'S, JUNE 29, 1974: LIMITED-AREA BRANCHING

SMSA	Total deposits (in thousands)	Largest bank	Percentage held by—	
			Largest 3 banks	Largest 5 banks
Akron, Ohio	\$1, 715, 910	34. 1	63. 9	83. 3
Erie, Pa.	855, 674	37. 8	80. 7	95. 9
Gadsden, Ala.	194, 692	21. 7	54. 1	76. 4
Jersey City, N.J.	1, 293, 049	29. 1	63. 8	86. 9
Pittsburgh, Pa.	9, 394, 094	49. 4	82. 6	91. 3
South Bend, Ind.	959, 949	22. 9	56. 2	71. 9

Source: Federal Deposit Insurance Corporation, "Summary of Deposits in All Commercial and Mutual Savings Banks, June 29, 1974", table 3, Washington, D.C.

TABLE 6.—RELATIVE SIZE OF LARGEST BANKS OR BANK GROUPS IN SMSA's, JUNE 29, 1974: UNIT BANKING

SMSA	Deposits (in thousands)	Percentage held by—		
		Largest bank	Largest 3 banks	Largest 5 banks
Austin, Tex.....	\$1,284,803	23.4	62.4	84.1
Chicago, Ill.....	41,102,853	22.2	50.3	57.1
Lawton, Okla.....	165,411	25.8	66.3	85.4
Sarasota, Fla.....	706,977	21.0	46.9	61.7
Springfield, Md.....	452,456	26.7	65.3	80.2
Wichita, Kans.....	1,203,085	26.5	51.5	63.5

Source: Federal Deposit Insurance Corporation, "Summary of Deposits in All Commercial and Mutual Savings Banks, June 29, 1974", table 3, Washington, D.C.

TABLE 7.—RELATIVE SIZE OF LARGEST BANKS OR BANK GROUPS IN SMSA's, JUNE 29, 1974: STATEWIDE BRANCHING

SMSA	Deposits (in thousands)	Percentage held by—		
		Largest bank	Largest 3 banks	Largest 5 banks
Asheville, N.C.....	\$380,010	40.0	77.2	96.4
Baltimore, Md.....	3,926,258	25.9	63.2	84.3
Hartford, Conn.....	2,313,167	45.5	87.2	90.3
Santa Rosa, Calif.....	707,364	37.5	74.5	87.4
Tucson, Ariz.....	1,005,386	31.3	70.6	91.9
Wilmington, Del.....	1,422,302	34.3	71.9	83.8

Source: Federal Deposit Insurance Corporation, "Summary of Deposits in All Commercial and Mutual Savings Banks, June 29, 1974", table 3, Washington, D.C.

Appendix 4

NONBANK ACTIVITIES OF BANKING ORGANIZATIONS: AN OVERVIEW

A cornerstone of Federal banking regulation has been the policy of separate banking from other lines of commerce. This is embodied in the National Bank Act, the Bank Holding Company Act and the Glass-Steagall Act, among others. This policy has been dictated by the judgment that banking institutions, that is, commercial banks and bank holding companies, require special treatment under the law in order to protect their solvency and to prevent abuses of the special economic power which appertains to these organizations. It is recognized that the commercial bank and its holding company, a virtual supermarket of lending and other financial activities, can by virtue of their economic power exert tremendous control over nonbanking businesses and can eliminate competitors for reasons unrelated to fair competitive practices. In addition, having this power at their disposal, they can be tempted to extend themselves into areas where the risks are unacceptable, given the need for a high level of fiscal integrity in banking organizations. The Federal government has recognized the public interest in supporting banking organizations by conferring significant benefits, including deposit insurance, limiting the issuance of charters and allowing the Federal Reserve System as a lender of last resort to put virtually unlimited funds into a bank to sustain it.

With this as a policy, and given the numerous limitations on how they may conduct banking activities, there has been an on-going attempt in the Congress and in banking regulatory agencies to seek authority to expand the activities of banking organizations into non-bank activities. The discussion below will attempt to outline major areas of such activity and some of the important milestones in that history. While there are different problems involved in banking organizations entering into other businesses, there are a number of basic problems that are frequently encountered, although the permutations will vary to some degree from activity to activity. These problem areas include the use of the power to loan to control the purchase of non-bank services from the banking organization; the granting of price

concessions on a loan only where non-banking services are purchased along with the loan; the ability to finance at preferential rates the activities of non-bank subsidiaries through the ability to obtain credit easier and cheaper by virtue of the affiliation with a banking organization; the jeopardy to the banking organization (and the government) from being required either voluntarily or involuntarily to expend funds to bail out a failing subsidiary; the elimination (or restructuring) of industries entered where such industries are currently characterized by a high level of competition and small businesses; and conflicts of interest where the banking organization finds itself as the advisor to the borrower, as well as his lender.

The activities of national banks are generally governed by the National Bank Act of 1864,¹ as amended, which prescribes certain express powers. The Act also provides that the bank shall have "all such incidental powers as shall be necessary to carry on the business of banking . . ."² It has been this so called "incidental powers clause" that has been the basis for bank regulatory agencies authorizing the expansion of national banks into new areas. As will be noted, the courts view this clause as limited to permitting activities necessary to accomplish express powers.

The nonbank activities of bank holding companies are those which the Board of Governors of the Federal Reserve System determine to be "so closely related to banking or managing or controlling banks as to be a proper incident thereto."³ This involves two tests: (1) is the nonbank activity "closely related"; and (2) is it likely to result in net benefits to the public when conducted by the bank holding company.⁴ The regulatory pattern works about as follows: (1) if the activity is to be conducted by a bank even where it is a subsidiary of a holding company, the National Bank Act or state law will control, depending upon whether the bank is a national or state bank;⁵ (2) if the activity is to be conducted by the bank holding company or a nonbank subsidiary, the Bank Holding Company Act applies. The Act as originally passed in 1956 covered only holding companies controlling two or more banks; the 1970 Amendments expanded coverage to all bank holding companies.

Finally, to put this matter into perspective, it should be recalled that in virtually all cases the principal subsidiary of a major bank holding company is a national bank. The bank holding company derives its financial reputation from the economic power of the banks, the assets of the banking subsidiary may be used to aid other parts of the holding company system, and in the view of a former Comptroller of the Currency, the holding company device was an appropriate way for a national bank to avoid federal regulation and judicial scrutiny:

"Commercial banks, tiring of the continual harassment from litigation, brought by a variety of non-bank competitors, attempted to devise an organization form which might be immune from such suits. The device of creating a parent holding company, under whose corporate umbrella a number of bank operations could be spun off as holding company subsidiaries, seemed to provide a possible answer."⁶

The latter view resulted in the proliferation of bank holding companies in the mid and late 1960's.⁷

¹ 13 Stat. 99.

² 12 U.S.C. § 24, Seventh.

³ 12 U.S.C. § 1843(c) (8); FRB Regulation Y.

⁴ The statute provides: "In determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a holding company 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."

⁵ 12 U.S.C. § 1843(c) (5) and 12 C.F.R. § 225.3(c).

⁶ See testimony of Comptroller Camp. Hearings, Senate Committee on Banking and Currency on S. 1052, et al., 91st Cong., 2d Sess. 188.

⁷ In 1965, there were 53 registered bank holding companies, controlling 468 banks, with total deposits of 27.5 billion, or 8.3% of all bank deposits. In 1971, there were 1,567 companies, with 2,420 banks. Deposits were up to 297 billion, or 55% of all bank deposits. 1974 estimates are 1,752 companies, 3,350 banks, 508 billion in deposits, or 68% of all deposits. "Bank Holding Company Facts, Spring 1975 Edition, Association of Registered Bank Holding Companies, Washington, D.C."

EXPANSION OF BANKING ORGANIZATIONS

The bank holding company permits the banking organization to conduct activities anywhere in the United States. Thus, for example, even though a national bank may act as a mortgage company, it is in many ways limited to the community, area or state where the bank is permitted to have offices. No such restraint applies where the activity is conducted in the holding company system outside of the bank. Accordingly, it should be noted that in addition to the nonbank activities noted below, that bank holding companies are presently authorized to engage in the following businesses: (a) mortgage company, (b) finance company, (c) credit card company, (d) factoring company, (e) loan servicing, (f) trust company, (g) leasing of real and personal property, (h) bullion dealer, et al. The Board, over the objection of the Federal Home Loan Bank Board, has held that owning a savings and loan association is proper.

In terms of economic power and concentration, certain facts are relevant. As of the end of 1973, about 4,000 commercial banks held \$687.5 billion in deposits. Bank holding companies controlled 46% of these banks and about 66% of the total deposits. Banking organizations also controlled 34 of the 100 largest mortgage companies, 27 of the 86 largest noncaptive finance companies, 13 of the 30 largest factoring companies,⁸ and through subsidiaries acting as advisors, 29 of the 100 largest real estate investment trusts. Trust department holdings totaled \$378 billion.⁹ On a local level, commercial banking is typically highly concentrated. In local geographic areas, it is not unusual to find the three largest bank organizations controlling 60, 70 or even 80 percent of the deposits in that area.¹⁰

Without considering activities of controlled finance companies, commercial banks provided 62% of all financing for automobiles in the second quarter of 1971.¹¹ In real estate finance, while commercial banks do not hold a majority of permanent mortgages, commercial banks: (a) are a major and necessary source of operating funds for mortgage companies and REITS; and (b) are the major source of construction financing. Thus, they are involved at one stage or another (or sometimes all) of real estate finance. As the holding company expands through control of REITs and mortgage companies, this control becomes more pervasive.

1. *Advisor to real estate investment trusts (REIT) and other investment companies.*—The Board of Governors of the Federal Reserve System ("Board") has authorized bank holding companies to act as advisors to real estate investment trusts (REIT) and other investment companies.¹² In this way, the banking organization can obtain fees from advising the REIT, can enter into loan transactions with the REIT and also through its trust department can see to the placement of securities of the REIT. The potentials for conflict of interest and ultimate liability in a down market are clear and have been manifest in recent years. Even though the REIT is publicly owned, its close identification with a banking organization has caused, in at least one prominent incident, the banking organization to voluntarily contribute funds to the REIT in an attempt to escape liability.

2. *Credit Life Insurance Company.*—National banks may not underwrite credit life insurance, but subsidiaries of bank holding companies may, according to Board rulings.¹³ The underwriting is limited to risks of the subsidiaries of the bank holding company. The Board has authorized this upon the representation that each will be reduced on the order of five to ten percent. The history of banking institutions, as well as other lenders, charging the maximum amount the law will allow for credit life insurance and the history of reverse competition in this area, is clear.

⁸ Samuel H. Talley, "Bank Holding Company Financing", paper prepared for delivery at the Conference on Bank Structure sponsored by the Federal Reserve Bank of Chicago, May 1-2, 1975, at 8.

⁹ *Trust Assets of Insured Commercial Banks*, Board of Governors of the Federal Reserve System, et al, Table 1, at 5.

¹⁰ See, *Summary of Deposits in All Commercial and Mutual Savings Banks*, Federal Deposit Insurance Corporation, June 29, 1974, Table 3.

¹¹ *Consumer Credit in the United States*, Report of the National Commission on Consumer Finance, 1972.

¹² 12 C.F.R. § 225.4(a) (5) (i).

¹³ 12 C.F.R. § 225.4(a) (9) (ii) (a) ; 12 C.F.R. § 225.128(C) (1) (i).

The control of the borrower by the lender is so patent that there has evolved the phenomenon of "reverse competition"; that is, business is given to the insurance company that pays the highest commission, which in turn is reflected in a higher premium. Since the borrower has no real choice, it being effectively controlled by the lender, the borrower will pay whatever is required. Credit life insurance is the only insurance where the state commissioners have had to regulate the level of compensation to the seller (the lender.)¹⁴

3. *Insurance Agencies.*—An amendment to the National Bank Act in 1916 specified that a national bank could conduct an insurance agency only in a community with a population of 5,000 or less.¹⁵ Beginning in 1963, the Comptroller of the Currency ignored the statute and held that selling insurance was a proper activity under the "incidental powers" clause of the National Bank Act¹⁶ until he was required by the Court of Appeals in 1968¹⁷ to change his view. The vehicle of the bank holding company was the mechanism for entering into insurance agency activities. Up until the late 1960's, the volume of this activity was relatively limited, but after the expansion of bank holding companies in the 1960's, the activity became much greater. The Board of Governors prior to 1971 had permitted a number of bank holding companies to operate insurance agencies, but these were generally localized geographically and limited in number. However, after the passage of the 1970 amendments to the Bank Holding Company Act,¹⁸ The Board in rulings and in adjudicatory proceedings stated that it would greatly expand the number of insurance agencies of bank holding companies and allow them into broad range of activities related to credit and financial transactions of the bank holding company.¹⁹ These issues are now pending in the courts. The court review has been the culmination of five years of litigation in an attempt to get this issue fully resolved and a complete record made thereon.²⁰

In the 1969-1970 Congressional hearings on the Bank Holding Company Act Amendments of 1970, the Board represented to the Congress that the activities previously authorized in this area had been relatively limited. But subsequent administrative action was not.

Studies²¹ have shown that the lender can effectively control the sale of insurance involved in the credit transaction by virtue of the inferior bargaining position of the borrower. This form of tying leads to the lessening of competition in the sale of insurance and the elimination of effective choice among sellers of insurance—all to the detriment of the consumer. The industry affected is currently characterized by many highly competitive units, most of them small businesses. The impact of bank holding company entry would be to change, for the worse, the structure of the industry. Banking organizations when selling insurance involved in their own lending transaction find themselves acting as insurance counselors to themselves (as holder of a security interest) and to the owner (borrower). This gives rise to conflicts of interest, e.g., in disputes over levels of deductibles.

4. *Casualty/Property Insurance Companies—Life Insurance Companies.*—National banks may not act as insurance companies. The Board has held that bank holding companies may not act as a life insurance company

¹⁴ See, National Association of Insurance Commissioners, *A Background Study of the Regulation of Credit Life Insurance and Disability Insurance*, November 1970. The credit insurance industry has been examined in several Congressional Committee hearings; in 1954 and 1967 by the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary, in 1961 by the same subcommittee on the House side, and in 1969 by the Subcommittee on Financial Institutions of the Senate Committee on Banking and Currency. See also, Federal Reserve Bank of Chicago, *Commercial Banking: Structure, Competition and Performance*, August 1967.

¹⁵ 12 U.S.C. § 92a.

¹⁶ 12 U.S.C. § 24, Seventh.

¹⁷ *Saxon v. Georgia Association*, 399 F.2d 1010 (5th Cir. 1968), affirming 268 F.Supp. 236 (N.D. Ga. 1967).

¹⁸ P.L. 91-607: 84 Stat. 1760.

¹⁹ See, e.g., 12 C.F.R. §§ 225.4(a)(9) and 225.128; *Application of First National Holding Corp.*, 60 Fed. Res. Bull. 738 (1974); *Application of Alabama Financial Group, Inc.*, 60 Fed. Res. Bull. 596 (1974).

²⁰ Two cases were led in a U.S. Court of Appeals when it appeared that the Board was trying to circumvent the requirement to develop a complete record.

²¹ See FTC Staff Memorandum, attachment to letter of FTC Secretary to Governor Bucher of the Federal Reserve Board, November 29, 1974.

(except for certain credit life insurance noted *able*.)²² It has not ruled under the 1970 Amendments on acting as a casualty and property insurance company; it considered such matters in 1971 and came to no decision. Several applications concerning such companies are pending. Prior to the 1970 Amendments, the Board ruled that such an activity was not permissible.²³

5. *Travel Agencies*.—The Comptroller of the Currency ruled in 1963 that a national bank could engage in the travel agency business²⁴ under the "incidental" powers clause of the National Bank Act.²⁵ The Comptroller relied on this clause because there was no express statutory authority allowing national banks to offer travel agency services. Litigation ensued. Initially, the Comptroller argued that his decision could not be challenged in court by travel agent competitors. It was necessary to go to the Supreme Court twice on the issue of standing to sue.²⁶ Ultimately, the lower courts ruled on the merits, and held that national banks are not authorized to operate travel agencies.²⁷ In March of 1973, the Comptroller announced that he would not seek the Supreme Court review of the *Arnold Tours* case. However, to this date, the Comptroller's Manual continues to purport to sanction the operation of travel agencies by national banks.

In another attempt to effect compliance with the rule of law established in the *Arnold Tours* case, a lawsuit seeking the issuance of a writ in the nature of mandamus was filed. Ten days later, the Comptroller issued a notice of proposed rulemaking in which he *still* persists in purporting to authorize travel agency activities on the part of national banks.²⁸ Comments have been filed by interested parties. Both the lawsuit and the rulemaking proceedings are presently pending.

On September 13, 1974, the Board of Governors of the Federal Reserve System noted receipt of an application by a bank holding company for approval of its retention of a travel agency.²⁹ Subsequently, at the request of an interested third party, the Board agreed to hold the application in abeyance and to conduct a rulemaking proceeding on the general question of whether the operation of a travel agency is a proper activity for bank holding companies.³⁰ A hearing has been held and this matter is currently pending.

The long history of bank regulatory agency attempts to support involvement by banking institutions in the travel business and the tremendous burden placed on competitors to vindicate their legal position is a case study in the imperfections in the regulatory structure. Banking organizations bring to the travel agency business no expertise or any service not now offered. There are more than 10,000 travel agencies in the United States. They are, for the most part, small businesses, and they make up a highly competitive industry. Banking organizations which have entered this industry bring with them the ability to control the purchase of travel services by virtue of their position as lenders and the ability to eliminate and lessen competition.

6. *Mortgage Guarantee Insurance Companies*.—National banks are not authorized to act as underwriters for mortgage guarantee insurance or other insurance.³¹ However, the Board of Governors proposed that bank holding companies should act as an underwriter of mortgage guarantee insurance.³² The Board decided that while the activity was appropriate for bank holding companies generally as being "closely related to banking,"³³ they would not authorize the activity *at this time* because of the newness of the business and the need *at this time* for bank holding companies to conserve their capital.

²² 12 C.F.R. § 225.126(b).

²³ *Transamerica Corporation*, 43 Fed. Res. Bull. 1014 (1957).

²⁴ 12 C.F.R. § 7.7475.

²⁵ 12 U.S.C. § 24, Seventh.

²⁶ See, *Arnold Tours v. Camp*, 400 U.S. 45 (1970); *Arnold Tours v. Camp*, 397 U.S. 315 (1970).

²⁷ *Arnold Tours v. Camp*, 338 F. Supp. 72 (D. Mass.), *aff'd*, 472 F. 2d 427 (1st Cir. 1972). See also, *American Society of Travel Agents Inc., v. Bank of America*, 385 F. Supp. 1084 (N.D. Cal. 1974).

²⁸ See, 40 Fed. Reg. 24767 (April 2, 1975). The actual "proposed revised interpretive rulemaking" was issued on March 28, 1975.

²⁹ 39 F.R. 33741 (September 19, 1974).

³⁰ 39 F.R. 38423 (October 31, 1974).

³¹ 12 U.S.C. § 92, 12 C.F.R. § 7.7100.

³² The Federal Home Loan Bank Board does not permit savings and loan service corporations to act as mortgage insurers. 12 C.F.R. § 545.9-1(a)(4)(ix).

³³ 60 Fed. Res. Bull. 727 (1974).

The Board considers this matter to be still on its agenda, with a view that it may ultimately be authorized. Mortgage insurance involves a company insuring the portion of a loan made beyond the normal loan limits of the lender. For example, if loans are normally limited to 80% of the value of the real estate, the lender would loan 90% and the borrower would obtain for the lender insurance covering the extra 10 percentage points. Prior to the depression, mortgage guarantee insurance was marketed by lending institutions and not one single mortgage guarantee insurance company survived.³⁴ Therefore, in order to provide the maximum protection by way of solvency, the better policy is to spread the risk and not have mortgage insurance written by lenders. Eliminating a joinder of the two also bars the likelihood of tying—where the borrower must obtain the insurance from the company affiliated with or chosen by the lender.³⁵

7. *Automobile Leasing.*—The Federal Reserve Board has never specifically authorized automobile leasing as a permissible non-banking activity for bank holding companies. However, its most recent regulatory action relating to the permissibility of “personal property” leasing in effect sanctioned wholesale and unrestricted entry by bank holding companies into this area of leasing, which is one where the leasing is more than just a financing device, but is inextricably involved in marketing autos.³⁶ The Board’s regulatory stance on the automobile leasing issue has not been consistent. In May 1973, in ruling on an individual bank holding company application to acquire a non-banking subsidiary, the Board authorized the acquisition on the express condition that the proposed subsidiary divest itself of its automobile leasing business, the Board noting that it had serious doubts about the permissibility of automobile leasing.³⁷ Some three months later, in August 1973, the Board proposed an amendment to its personal property leasing rule which would have had the effect of prohibiting bank holding companies from engaging in automobile leasing.³⁸ In an about-face, in March 1974, the Board adopted an amendment to its personal property leasing rule which had just the opposite effect of its July 1973 proposed amendment.³⁹ The Board’s final action not only did not limit or prohibit automobile leasing activities, it authorized wholesale entry of bank holding companies in this field.

There is no explanation for this turnabout in administrative policy. Significant portions of the administrative record considered by the Board in reaching its decision have been deleted and the Board has refused to make these portions available for purposes of judicial review. There are record indications, however, that the regulatory decision was reached improperly. These include certain Board staff memoranda which contained (i) a recommendation from the staff that the Board take no action on a recommended consumer protection provision for fear that this would hurt the Board’s chances in an appeal, and (ii) a staff recommendation that the Board act quickly in order to limit the issues which parties could raise in a pending application proceeding for acquisition of an automobile leasing concern.

In 1963, the Comptroller of the Currency issued an interpretation of the National Bank Act declaring that national banks were authorized to engage in the leasing of personal property.⁴⁰ Pursuant to that interpretation, several national banks entered the automobile leasing business. This interpretation was the subject of litigation in the federal district court sitting in Seattle. The district court ruled that national banks were only authorized to engage in “open-end” automobile leasing, *i.e.*, where the bank did not assume any

³⁴ An intensive study was conducted in 1934 for the Governor of New York State, the Alger Report. It recommended against joining mortgage insurers and lenders.

³⁵ The Regulations of the Federal Home Loan Mortgage Corporation, 12 C.F.R. § 500 *et seq.* recognize this problem by forbidding lenders to receive a commission for insurance written in their own risks. However, at hearings before the Board of Governors, witnesses for bank holding companies stated that this type of restriction was easily evaded by two lender affiliated insurance companies “trading” business, that is the mortgage insurance company of bank holding company A writes insurance on the loans of bank holding company B, and A has its loans covered by B’s insurance.

³⁶ Amendments to 12 C.F.R. § 225.4(a) (6), published at 39 Fed. Reg. 11254 (March 27, 1974).

³⁷ *Centran Bancshares Corporation*, 59 Fed. Res. Bull. 471 (1973).

³⁸ Proposed amendments to 12 C.F.R. § 225.4(a) (6), published at 38 Fed. Reg. 21436 (August 8, 1973).

³⁹ See Footnote 1, *supra*.

⁴⁰ 12 C.F.R. § 7.3400.

speculative risk whatsoever and the lessee guaranteed the resale value of the automobile. That ruling is being appealed.

The ultimate result of financial institution activity in this area will be elimination of a large segment of the independent automobile leasing industry. Domination of this industry by financial institutions will vest them with overwhelming economic bargaining power vis-a-vis automobile dealers. Further, in order to protect the reputation of their leasing operations, banks and bank holding companies will have to engage in selling automobiles at the expiration of the lease term. While they have contracted away the risk of loss, which will be borne by the lessor-borrower, they do have the obligation for arranging for the sale of the automobiles at the end of the lease term. This places them squarely in the automobile sales business. Finally, as an incident to automobile leasing, banking organizations are offering more and more ancillary services like those offered by auto dealers, *e.g.*, selling parts, tires, obtaining license plates, etc.

8. *Data Processing Company.*—The Board of Governors has authorized bank holding companies to engage in data processing activities independent of lending or other activities provided the nature of the activity is one that is also employed in banking activities.⁴¹ The Comptroller of the Currency has authorized similar, although not the same activities, for national banks.⁴² In addition, the Comptroller has ruled that in certain respects the charges for data processing services are not covered by the anti-tying provisions of Section 106 of the Bank Holding Company Act Amendments of 1970.⁴³ Accordingly, the bank can offer reduced rates for data processing charges, based on giving a credit for the value to it of demand deposits provided by the customer on which it is forbidden to pay any interest. This exclusion from tying is an incentive for predatory pricing.

More generally, engaging in data process activities places the banking organization in another line of commerce, one often marked by risk factors greater than banking.

9. *Courier and Armored Car Services.*—On November 17, 1971, the Federal Reserve Board published a proposed rulemaking which would authorize bank holding companies to provide armored car and courier services.⁴⁴ These activities involve operating motor carriers to pick up and deliver goods that require prompt transmission (courier services) and/or a high level of security (armored car services). The Board subsequently determined that bank holding companies should be permitted to engage in the courier service industry.⁴⁵ No decision was made on the performance of armored car services.⁴⁶ The Board's rulemaking action on courier services is now under court review.

In 1963, the Comptroller of the Currency issued a ruling to the effect that national banks were authorized to "provide messenger service by means of an armored car or otherwise."⁴⁷ Like several other interpretations of the National Bank Act issued by the Comptroller in the early 1960's, this interpretation did not pass judicial muster. In *First National Bank v. Dickinson*, 396 U.S. 122 (1969), the Supreme Court invalidated this regulation insofar as it purported to authorize a national bank's operation of an armored car in a state having branch banking restrictions. The Court held that the armored car operation constituted a "branch bank" and that, in a state having restrictions on branch banking, the operation of an armored car service by a national bank was illegal.

Courier services can be largely utilized by financial institutions as a loss leader to further the business of the bank or the banking subsidiary, particularly in the area of correspondent bank relationships. Subsidized

⁴¹ 12 C.F.R. §§ 225.4(a) (8) and 225.118. See also, 12 C.F.R. § 225.123(g).

⁴² Revision of 12 C.F.R. § 7.3500, published in 39 Fed. Reg. 14192 (April 22, 1974).

⁴³ See, 39 Fed. Reg. 14194 (April 22, 1974).

⁴⁴ 36 Fed. 21897.

⁴⁵ 12 C.F.R. § 225.4(a) (11).

⁴⁶ This "non-decision" was unusual inasmuch as there was no evidence introduced in the record to support performance of this activity by bank holding companies. The only evidence introduced on this issue was negative. There was a clear requirement on the Board to find that armored car services were not a permissible activity for bank holding companies and the Board's failure to so find was an indication of where the Board's sympathies lie.

⁴⁷ *Comptroller's Manual for National Banks*, § 7490.

courier operations will have a decidedly adverse effect on smaller bank competition and on independent courier companies which depend solely on transportation revenues. Bank courier operations will also have a negative impact on development and maintenance of efficient transportation services available on an non-discriminatory basis to all users.

The most prominent use of armored car services by financial institutions is to serve as a "rolling branch" of the bank or bank subsidiary. This use disadvantages smaller bank competitors by depriving them of deposits and other bank business. Independent armored car companies are also competitively injured because of the unreasonably low rates set by financial institutions offering armored car services.

10. *Consulting Services.*—Bank holding companies are currently authorized to engage in a wide variety of consulting activities, including both economic advice and management services, and the regulatory trend in recent years has been toward expanding the scope of permissible activities in this area.

Under the "services" exemption of § 4(c)(1)(C) of the Bank Holding Company Act of 1956, holding companies were permitted to retain their shares in subsidiaries providing management consulting services to themselves and their banking affiliates. Recognition of the inherent conflict of interest problems in this field of activity, however, led initially to a total prohibition on providing such services to non-affiliated companies or banks.⁴⁸ Economic consulting is permitted in a number of areas by 12 C.F.R. § 225.4(a)(5). Among the authorized activities are acting as investment or financial advisor to a mortgage company or REIT, giving portfolio investment advice to any person, providing general economic information and advice, (including economic statistical forecasting and industry studies), and giving financial advice to State and local governments.

Subsequently, the Board has expanded the range of activities in both the economic and management consulting areas. Effective February 1, 1972, the Board amended 12 C.F.R. § 225.4(a)(5) to allow bank holding companies to act as investment advisers to investment companies registered under the Investment Company Act of 1940.⁴⁹ The Board at that time continued to distinguish economic and investment consulting services from management consulting services, which were still held to be not "closely related."⁵⁰

As to this latter point, however, the Board has reversed itself, and has added to Regulation Y a new § 225.4(a)(12), under which providing management consulting services to non-affiliated banks is now considered to be a permissible nonbanking activity, subject to certain conditions.⁵¹ Subject to the "public benefits" test of 12 C.F.R. § 225.4(b)(2), the Board has approved applications by bank holding companies to form and acquire the shares of management consulting firms.⁵²

National banks regulatory provide investment and other economic advice to their customers through the operation of trust departments. Such activities are subject to regulation and examination by the Comptroller.⁵³ There appears to be no authority for national banks to provide bank management consulting services to outside organizations. The regulations promulgated by the Comptroller of the Currency, which provide that national banks can provide some non-banking services to customers,⁵⁴ do not mention management consulting services.

11. *Underwriting Securities.*—The incidental powers clause of the National Bank Act expressly prohibits national banks from underwriting any issue of stock or securities, except for obligations of the United States or any state

⁴⁸ See, *First Commerce Corporation*, 58 Fed. Res. Bull. 674 (1972); see also, 12 C.F.R. §§ 225.4(a)(5)(iii), n.2 and 225.115.

⁴⁹ See 12 C.F.R. § 225.4(a)(5)(ii).

⁵⁰ See, 12 C.F.R. § 225.4(a)(5)(iii), n.2.

⁵¹ The amendment became effective February 26, 1974, and is set out at 39 Fed. Reg. 8318 (March 5, 1974). The Board simultaneously issued an interpretive ruling, which describes those activities the Board considers to be management consulting.

⁵² See, e.g., *The Citizens and Southern Corporation*, 60 Fed. Res. Bull. 226 (1974). This application was approved on the same date as the new regulations became effective.

⁵³ See 12 C.F.R. Part 9.

⁵⁴ See 12 C.F.R. §§ 7.7100, et seq.; §§ 7.7376, et seq.

or subdivision thereof.⁵⁵ This prohibition was contained in § 16 of the Glass-Steagall Act of 1933, 48 Stat. 184, in response to concern over the effect that such activities had had on bank collapses in the late 1920's. The same Act contained sections prohibiting common directors, officers, and employees between commercial banking institutions and underwriting firms,⁵⁶ and provided criminal penalties⁵⁷ if commercial banking institutions and investment banking firms were not separated.

Court cases have interpreted these sections so as to continue the strict separation of commercial and investment banking mandated by the Glass-Steagall Act. The "general obligations" exception of § 16, for example, has been narrowly construed to include only obligations issued by an agency with general taxing powers and based on the full faith and credit of the issuing entity. *Baker, Watts & Co. v. Saxon*, 261 F. Supp. 247 (D.D.C. 1966), *aff'd*, 392 F.2d 497 (D.C. Cir. 1968).⁵⁸ On the other hand, the Supreme Court has given the term "securities" in the same section a broad construction, and has held that the issuance by a bank of redeemable units of participation in a mutual fund operated by the bank is an illegal underwriting of securities. *Investment Company Institute v. Camp*, 401 U.S. 617 (1971).

In spite of these clear statutory and judicial expressions, the Board has ruled that a bank holding company can organize and operate a closed end investment company.⁵⁹ The Board, while acknowledging that in light of the Glass-Steagall Act and the Supreme Court's opinion in the *ICI* case, a bank holding company cannot operate an open-end company, states that a closed end company does not make its shares redeemable, and issues shares only at "infrequent intervals" after it is organized.⁶⁰ In allowing bank holding companies to operate such companies, the Board is refusing to apply to bank holding companies 40 years of consistent statutory and judicial authority as it has been applied to national banks, on the narrow bases set out above, and is arguably ignoring the broader lessons of that authority on the need to separate completely commercial banking from investment banking.⁶¹

On a related issue, the Comptroller has recently ruled that national banks may provide an Automatic Investment Service (AIS) to their customers.⁶² The service involves an automatic monthly deduction from the customer's checking account which is applied toward the purchase of shares of stock in companies selected by the customer from a list provided by the Bank. In making the purchases through a broker, the bank pools the amounts from all customers who wish to purchase the same stock, and the price per share for each customer is the average of the prices paid for all lots of the same stock purchased during the acquisition period.

The Comptroller ruled that national banks could advertise the AIS, and conduct it on a for-profit basis. The latter point was contrary to the prior position of the Comptroller, who had for many years taken the position that the bank could not profit from the agency relationship. In making the new ruling, the Comptroller considered and rejected claims that several possible conflict of interest situations would be presented by banks providing AIS.

⁵⁵ 12 U.S.C. § 24, Seventh.

⁵⁶ Glass-Steagall Act §§ 21, 32; 12 U.S.C. §§ 378(a), 78.

⁵⁷ *Id.*, 12 U.S.C. § 377.

⁵⁸ The Comptroller's 1963 ruling that obligations of other entities without taxing power, e.g., the Port Authority of New York, included in the § 16 exceptions was expressly held invalid. The Comptroller's Regulations respecting regulation of investment securities are now in line with the holding in the case. See 12 C.F.R. § 1.3.

⁵⁹ 12 C.F.R. § 225.125(f).

⁶⁰ These are the sole distinctions noted by the Board between an open end and a closed end investment company. Further, the Board has decided that holding companies are not subject to the provisions of § 21 of the Glass-Steagall Act.

⁶¹ Though the initial offering of securities in a closed-end investment company advised and/or operated by a bank holding company is conducted by investment bankers in conventional underwritings, banks "... are not prohibited from offering many of the corporate financial services, other than underwriting, traditionally offered by investment bankers." Black, et al., *The Banking System: A Preface to Public Interest Analysis*. Public Interest Economics Center, Washington, D.C. 1975.

⁶² Comptroller's letter, June 10, 1974, reprinted in CCH, *Federal Banking Law Reporter*, ¶ 96,171. Authority is found in 12 U.S.C. § 24 Seventh, which allows banks to purchase stock on a customer's account.

ADDENDUM TO NONBANK ACTIVITIES OF BANKING ORGANIZATIONS

CURRENT DEVELOPMENTS

A. Procedures

In two cases, the courts have ordered the Federal Reserve Board to hold formal adjudicatory hearings where parties had raised issues under the public benefits portion of the test set forth in Section 4(c)(8) of the Bank Holding Company Act of 1956, as amended. In both cases, the Board had refused to order formal hearings even though questions of fact under the public benefits test were put at issue.¹

B. Travel Agencies

The Federal Reserve Board has determined that the operating of a travel agency is an activity which is not "closely related" to banking under Section 4(c)(8) of the Bank Holding Company Act of 1956, as amended.²

C. Automobile Leasing

The Federal Reserve Board motioned the United States Court of Appeals for the District of Columbia Circuit to remand its determination that certain types of leasing activities are "closely related" to banking under Section 4(c)(8) of the Bank Holding Company Act of 1956, as amended.³

D. Data Processing Services

A United States District Court has ruled that national banks may not offer data processing services involving accounts receivable accounting for merchants.⁴

E. Courier Services

A court upheld the Federal Reserve Board's rules concerning the participation by bank holding companies in the provision of courier services.⁵

Appendix 5

(Excerpt from an Analysis of the Retail Insurance Industry
by Prof. Emmett J. Vaughan, University of Iowa)

THE PROPERTY AND LIABILITY INSURANCE MARKETING SYSTEM

The following discussion of the property and liability insurance distribution system is presented to provide a general framework for the discussion which follows, and also because certain of the applications allude to current developments within the industry and cite these developments as factors which favor entry into this market.

THE BUYER'S SIDE OF THE MARKET

The insurance market, of course, has two sides: the sellers side and the buyers side. Before discussing the sellers side, it may be useful to take a brief look at the buyers side. The buyers side is composed of two general classes, usually referred to as 1) Personal lines insureds and 2) Commercial lines insureds. The term "personal lines" refers to the individual or family unit buyer, as contrasted with business firms which, with all other institutions are

¹ *Independent Bankers Association of Georgia v. Board of Governors of the Federal Reserve System*, 516 F.2d 1206 (D.C. Cir. 1975); *American Bancorporation, Inc. v. Board of Governors of the Federal Reserve System*, 509 F.2d (8th Cir. 1974).

² See 41 Fed. Reg. 5134 (1976).

³ *National Automobile Dealers Association, Inc. v. Board of Governors of the Federal Reserve System*, Docket No. 74-1431 (D.C. Cir., October 22, 1975).

⁴ *National Retailing Corporation of Arizona v. Valley National Bank*, Docket No. 71-410-PHX-WEC (D.C. Ariz. February 2, 1976).

⁵ *National Courier Association v. Board of Governors of the Federal Reserve System*, 516 F.2d 1229 (D.C. Cir. 1975).

referred to as "commercial lines." It is also possible to further subdivide the commercial line insureds into classifications based on size, complexity, or geographic extent. For example, The General Motors Corporation would be classed as a commercial line insured, but so too would a local Buick dealer franchised by the Buick Division of General Motors. For rather obvious reasons, these two "commercial line insureds" are so dissimilar as to constitute different markets.

While any division of the property and liability insurance field is somewhat arbitrary, for convenience in this discussion, we will refer to the buyers side of the market in terms of personal lines insureds, and commercial line insureds, bearing in mind that the commercial line area includes a wide range of buyers from giant commercial accounts to small mercantile establishments.

The distinction between the different classes of commercial line insureds is important because this distinction has previously been ignored in certain testimony which discusses the growth of the largest national brokerage firms.

THE SELLERS SIDE—THE AGENT

From many points of view, the most important person in the entire insurance transaction is the agent. With few exceptions, the marketing mechanism in the insurance industry revolves around the agent, however, his role varies in different lines of insurance, and the relationship between the agent and the company he represents can be, and often is, quite varied. Through a process of evolution, several marketing forms have developed, each of which has as its goal the attainment of efficiency in distribution and service.

In the field of property and liability insurance, companies may be classified into two groups based on their distribution system: (a) those who operate through the American Agency System and (b) the "direct writers." The agents who operate through the American Agency System are known as "independent agents," while those who represent direct writers are called "captive agents."

The American Agency System.—The independent agent normally represents several companies, dividing the policies he sells among those companies according to his choice. He owns his expirations, which means that he may place the renewals of policies he has sold with some other insurer if he chooses to do so. This is in contrast to the European system under which an agent represents only one company. One implication of the ownership of renewals by the independent agent is the fact that it prevents the insurance company from attempting to pay a lower commission on renewal business. If a company represented by an independent agent were to attempt to pay a lower commission on renewal business than on new business, the agent could simply place the policy with a different company, making it new business for that company.

Direct Writers.—Direct writing companies operate through the mail, (as in the case of GEICO), through salaried representatives (as in the case of The Liberty Mutual Insurance Company), or through exclusive or "captive agents" (as in the case with Nationwide, State Farm, and Allstate).¹ The compensation of the salesman may be in the form of a salary, or it may be a commission, based on the premium volume. In the case of the exclusive agent, it is normally in the form of commission. The important point is that the agent or the salaried employee does not own the expirations. He has no choice as to where the policy is to be renewed. Since the agent cannot transfer the business he writes to another insurer, the direct writing company can pay an infinitesimally small renewal commission or none at all.

The ownership of renewals is the most important difference between the two types of agents, and from this difference arises still other differences in the method of operation. Since the direct writing agent receives little or no commission on renewals, the production of new business is of crucial importance. It also means that in most jurisdictions, the policies sold by direct writers are somewhat lower priced than those of independent agents. The independent agent, on the other hand, places greater emphasis on the retention of accounts he presently services. As a matter of fact, the independent agent's interest in

¹ Technically, companies that operate through exclusive agents are not "direct writers," but rather "exclusive-agent companies." However, the term "direct writer" is commonly used in reference to both companies operating through salaried representatives and those operating through exclusive agents.

his obligation to his clients is one of the essential themes of the advertising program of the independent agents.

BROKERS

Although the insurance agent is first and foremost the representative of the insurance company he serves in a dual agency capacity, and also acts as an agent of his clients. An insurance broker, on the other hand, is an agent only of the insured. Although he is the agent of the insured, the broker normally receives his compensation in the form of a commission from the company. The fact that the broker is not an agent of the insurance company means that he does not have the power to bind the company to a risk. He merely solicits business from his clients and then places the business with an insurer. Brokers represent an important segment of the insurance marketing mechanism, particularly in large cities, where they control large segments of the market.

The largest of the brokers operate on a national and international basis offering a wide array of insurance, engineering, and consulting services and concentrate their efforts in the servicing of giant corporations. These large brokerage houses have long been an important segment of the market structure. However, until recently, their activities were confined only to the largest cities such as New York, Chicago, and Boston. As they have expanded into new areas and gained penetration in those new areas their share of the national market has naturally increased.

COMPETITION WITHIN THE INDUSTRY

Competition within the insurance industry today is fierce; perhaps more so than any time in history. This competition takes place mainly in two areas: price competition and quality competition.

Price Competition.—The price competition within the industry takes place between companies. Insurance companies compete on the basis of price by attempting to offer a lower priced product than do other companies dealing in the same line of insurance. It is sometimes puzzling that insurance companies can charge significantly different premiums for identically the same coverage. The price of insurance, like most prices, is a function of the cost of production. The obvious answer to the question of how various insurance companies can charge different premiums for identically the same coverage is that their costs also vary significantly. The following costs are common to all insurance companies:

1. Losses.
2. Loss adjustment expense.
3. Acquisition expense.
4. Administrative expense (company overhead).
5. Taxes.

The first of the costs listed can be an area of significant difference between companies. If a company can succeed in obtaining its customers from a better class of risks, its loss costs will be lower. If loss costs decline, adjustment expense also declines. Some companies, through selective underwriting, emphasize this component of premium cost, thereby reducing their costs and the premiums at which they sell insurance.

The third cost, the cost of production, can also be altered to reflect substantial premium savings. The bulk of production costs have traditionally been agents' commissions. Some companies, such as the direct writers, have been able to reduce premium costs by reducing or eliminating agents commissions. Efficiency in administration, through the use of mechanized billing and automated renewal procedures not only saves administrative costs, but also gives the company greater control over policy renewals. These differences in costs all help to explain the differences in premiums among companies. If a company is successful in reducing any of these costs below those of its competitors, it stands to reason that the company will be able to offer its coverage at a lower price.

In the area of property and liability insurance, price competition takes place between the various types of companies. Thus, mutual companies compete with stock companies, bureau companies compete with non-bureau companies, and companies operating through the American Agency System compete with direct writers. The pricing decision is made for each company by

actuaries, either through cooperative rate-making organizations called "bureaus" or by actuaries employed by the company itself. These prices are based on anticipated costs.

The agent does not (except in extremely isolated cases) participate in setting the price of the product. Exceptions exist in the case of extremely large accounts in which the commission is negotiated, and the final commission agreed upon is a factor in the final premium.

In this area, price competition takes place not only between companies, but between agents and brokers as well. The larger the account, the greater the likelihood that price competition between agents and brokers will be involved.

In general, however, the pricing of the product by his companies is a factor outside of the control of the agent. Price competition between agencies does, of course, take place, but this price competition is based on the price competition between the companies that they represent. There are differences in price among companies, and in the selection of the companies that he will represent, the agent has some control over the price of the contracts that he will sell, but the selection of a company sets the price that the agent must charge at the rate that his company charges. Agencies operating through the American Agency System represent companies that are similar in their pricing structure. In many instances, competing agencies represent the same companies, and the contracts that they sell are identical in price. With the price of their products fixed, the emphasis in the competition among agencies is on quality competition.

Quality Competition.—In a real sense, the insurance agent does not sell insurance. It is possible to purchase insurance without the services of an agent. If the consumer elects to purchase his insurance from an agent rather than directly from a company, the cost is likely to be somewhat higher, and the additional premium that the consumer pays is compensation to the agent for the function which he performs; that of advising the insured. In a sense, the insurance premium is composed of two parts: one part goes to the insurance company as consideration for the protection granted, the other part goes to the agent for the advice which he provides. Basically this advice consists of an analysis of the needs of the client, recommendation for coverages, selection of an insurer, and assistance in claim settlement at the time of a loss.

In the area of service, competition depends to a great extent on the technical competence of the personnel involved in the agency or brokerage house. For this reason, the large national brokers generally are not considered direct competitors of small local agencies, since the small local agencies do not have the facilities to service the giant national accounts that represent the clientele of the national brokers. On the other hand, there are many larger local agencies that compete effectively with the national brokers.

Overall, the competition within the insurance distribution field is extremely vigorous. Local independent agencies compete with each other and with direct writing companies in the personal lines field. In the case of smaller and medium sized commercial accounts, the situation is essentially the same. In the case of the giant commercial accounts, larger independent agents compete with each other and with the direct writing companies, and also with the large national brokers. The competition in all instances is based in part on price competition and in part on service.

Appendix 6

SELECTED STATISTICAL MATERIAL CONCERNING THE INSURANCE INDUSTRY

NET PREMIUMS WRITTEN BY LINE

Total premiums written by insurance companies in 1973 in the U.S. for all types of insurance approximated \$90 billion.

Purchases of property and liability insurance increased about 6.6 per cent in 1973. Net premiums written* by property and liability companies totaled about \$42 billion in 1973.

Approximate premium totals for principal property, liability and allied lines of insurance in 1971, 1972 and 1973 are tabulated below. Not included are miscellaneous lines which together produced premiums of more than \$500 million in 1973.

TOTAL NET PREMIUMS WRITTEN, 1971-73

	1971	1972	1973
Auto Liability, private passenger.....	N.A.	\$8,113,144,000	\$8,000,000,000
Auto Liability, commercial.....	N.A.	2,254,044,000	2,750,000,000
Total auto liability.....	\$9,976,931,000	\$10,367,188,000	\$10,750,000,000
Auto physical damage, private passenger.....	N.A.	4,987,221,000	5,300,000,000
Auto physical damage, commercial.....	N.A.	1,028,639,000	1,100,000,000
Total auto physical damage.....	5,439,227,000	6,015,860,000	6,400,000,000
Total, all automobile.....	15,416,158,000	16,383,048,000	\$17,150,000,000
Liability (other than auto).....	2,380,950,000	2,555,213,000	2,700,000,000
Fire insurance and allied lines.....	3,172,236,000	3,405,669,000	3,600,000,000
Homeowners multiple peril.....	2,833,181,000	3,315,803,000	3,900,000,000
Farmowners multiple peril ¹	N.A.	N.A.	185,072,000
Commercial multiple peril.....	1,659,740,000	2,078,069,000	2,500,000,000
Workmen's compensation.....	3,660,066,000	4,104,090,000	4,750,000,000
Inland marine.....	884,386,900	968,070,000	1,050,000,000
Ocean marine.....	496,095,000	576,960,000	650,000,000
Surety and fidelity.....	605,021,000	660,700,000	700,000,000
Burglary and theft.....	136,079,000	138,331,000	130,000,000
Crop Hail.....	123,875,000	132,368,000	192,354,000
Butler and machinery.....	125,695,000	129,440,000	135,000,000
Glass.....	39,697,000	39,232,000	35,000,000
Credit.....	47,364,000	70,465,000	90,798,000
Aircraft.....	186,694,000	181,455,000	167,475,000

¹ Previously included in homeowners multiple peril figures.

Source—Insurance Facts 1974, Insurance Information Institute (1974).

NET PREMIUMS WRITTEN 1949-1973

Total net premiums written by property and liability companies for all lines, including accident and health, have risen from \$6.4 billion in 1949 to an estimated \$42 billion in 1973. While many insurance groups have transferred their accident and health writings from their property and liability affiliates to their life insurance affiliates, accident and health premiums accounted for about \$1.5 billion of the 1973 total of premiums written by property and liability companies.

TOTAL NET PREMIUMS WRITTEN FOR ALL LINES OF PROPERTY AND LIABILITY INSURANCE, 1949-73

[000 omitted]

	Accident and health	All other	Total		Accident and health	All other	Total
1949.....	(1)	-----	\$6,356,176	1961.....	\$1,484,526	\$13,989,146	\$15,473,672
1950.....	(1)	-----	6,866,288	1962.....	1,628,825	14,405,364	16,034,189
1951.....	\$494,137	\$7,280,595	7,774,732	1963.....	1,362,764	15,811,924	17,174,688
1952.....	549,880	8,220,090	8,769,970	1964.....	1,520,603	16,796,209	18,316,812
1953.....	650,556	9,021,980	9,672,536	1965.....	1,643,648	18,419,820	20,063,468
1954.....	705,365	9,202,407	9,907,772	1966.....	1,659,145	20,340,912	22,000,057
1955.....	803,947	9,735,379	10,539,326	1967.....	1,690,329	22,138,588	23,828,917
1956.....	915,624	10,214,448	11,130,072	1968.....	1,778,903	23,247,133	25,026,036
1957.....	1,038,140	11,058,160	12,096,300	1969.....	1,980,032	27,244,869	29,224,901
1958.....	1,115,586	11,712,680	12,828,266	1970.....	1,903,841	30,958,185	32,862,026
1959.....	1,244,673	12,839,687	14,084,360	1971.....	1,010,331	34,704,563	35,714,894
1960.....	1,357,600	13,615,031	14,972,631	1972.....	1,255,525	38,061,998	39,317,523
				1973.....	1,500,000	40,575,000	42,075,000

¹ Prior to 1951 accident and health premiums were not reported separately.

Source: Best's Aggregates & Averages (1973 figures are preliminary estimates).

TABLE 1.—LIFE INSURANCE PENETRATION RATES FOR OCTOBER AND NOVEMBER 1973 FOR SELECTED STATES

States	Company A	Company B—		Company C—		Company D—	
		October	November	October	November	October	November
Florida.....	97	97	98	98	95	93	92
Washington.....	98	98	98	94	95	93	92
Michigan.....	97	98	98	98	98	92	95
Pennsylvania.....	99	97	97	96	90	88	81

Appendix 7

EXCERPTS OF MATERIALS CONCERNING THE SALE OF CREDIT LIFE INSURANCE

On November 19, 1974, the Federal Trade Commission provided the Federal Reserve Board with an extensive analysis of the credit life insurance problem.¹

"(4) In the course of our enforcement activities under the Truth in Lending Act, we have encountered two major problem areas which we believe threaten to undermine the concept of Truth in Lending.

(a) *Credit Insurance*

"The first problem area is the sale of credit life and credit accident and health insurance in connection with consumer credit transactions. Under the Truth in Lending Act, premiums paid by the borrower for credit insurance may be excluded from the disclosure of the "finance charge" for the loan, if the insurance is requested in writing by the consumer after written disclosure by the creditor that the insurance is optional and not a factor in the creditor's decision to extend credit. Some creditors have attempted to circumvent the requirements of the Act by means of practices which lead borrowers to believe that their election of insurance coverage is necessary to obtain the loan. The effect of the practices is to override or negate the Truth in Lending disclosures.

"As you know, we have addressed this problem in our 1972 and 1973 annual reports to the Board, and during the past year the Commission staff has continued its efforts in this field. The staff's preliminary findings indicate that the Commission's earlier credit insurance action, *In the Matter of Commercial Credit*, (Docket No. C-2430) 82 FTC 1841 (June 26, 1973), has had little deterrent effect on other creditors subject to our jurisdiction, and that penetration rates (i.e., the percentage of all loans made in which credit insurance is included) for credit life insurance continue to approach 100% for many major loan companies.

"The Board's 1973 report to Congress noted: The Commission has evidence indicating that certain creditors . . . have attained penetration rates in the sale of credit life insurance that approach 100%. . . . Should these penetration rates prove to be widespread, an amendment to the Regulation or, if necessary, the Act may be in order.

"As an attachment to this letter, we are including a staff discussion which reviews the experience of the staff in this area. (See Attachment A.)

"The Commission is continuing its case by case approach to this problem, focusing on the consumer finance industry. The staff currently has underway investigations designed to bring a substantial part of the direct personal loan market into compliance. It is not anticipated, of course, that the Commission's adjudicative procedures will bring into compliance the myriad of small creditors and installment sellers who may also be evading the requirements of the Act with regard to the sale of credit insurance.

"The problems we have encountered in the credit insurance area appear to be in no way alleviated by the present form of Regulation Z. That is, the present provisions of Section 226.4(a)(5) of Regulation Z do not ensure the voluntary election of credit insurance since those creditors who wish to evade the intent of this section may do so by making disclosures which are in

¹ Letter from Charles A. Tobin, Secretary, Federal Trade Commission, to Jeffrey M. Bucher, Member, Federal Reserve Board, November 19, 1974 (FTC report to the Board in connection with the Board's Annual Report to Congress, 1974).

ostensible compliance with the Regulation, while orally informing or indicating to the consumer that the insurance is required. The result is that substantial numbers of consumers receive disclosures which do not reflect the true costs of their loans.

"We, therefore, repeat our suggestion that the Truth in Lending Act be amended to provide that the cost of credit insurance purchased in connection with a credit transaction be included in the finance charge regardless of whether its selection is "voluntary" or not. We are persuaded that this recommendation is consistent with the expressed purpose of the Act, to ensure full disclosure of the cost of credit. We also feel that this approach is necessitated by the fact that, because of the inherently unequal relationship which exists between a borrower and creditor and the creditor's economic self-interest in the sale of credit insurance, no free choice is available to the consumer through any combination of point of sale or loan disclosures, however thorough they may be.

"We are cognizant of the fact that the Board has previously rejected this suggestion on the grounds that such a provision might result in an unfair burden to those creditors who do not require insurance; tend to blur the distinction between those creditors who require insurance and those who do not; and encourage creditors who presently do not do so to require the insurance, to the detriment of those persons who may not desire it. Our position, however, is that it is difficult if not impossible to distinguish between "voluntary" and "required" insurance in a consumer credit transaction, and that the purposes of full and accurate disclosure of the cost of credit can best be served by eliminating the essentially illusory distinction. In addition, we note that disclosure of premium costs for credit insurance as part of the finance charge may have the additional benefit of lowering the premiums themselves, since for the first time it will become advantageous for the creditor to charge the consumer the lowest rate possible (in order to keep the finance charge and APR at a reasonable level), instead of the highest legally permissible rate as is now the case.²

Finally, we also would hope that the competition theory on which the concept of Truth in Lending is based, will tend to prevent the result of mass required insurance which concerns the Board. We concede, however, that Federal legislation may be necessary which prohibits a creditor in a consumer credit transaction from requiring the purchase of credit life or credit accident and health insurance as a condition to the extension of credit, and note that legislation of this nature has already been adopted by some States.³

Although we feel that the inclusion of the cost of credit insurance as part of the finance charge is clearly the best solution, there is an alternative solution to this problem which the Board should consider. Regulation Z could be amended to require that no solicitation for the purchase of optional credit insurance may be made until five days (or other reasonable time) after the loan has been consummated, and at that time only by mail, using the form specified by the Board in the Regulation. It is our belief that this type of amendment of Regulation Z is within the Board's power under Section 105 of the Act. *Mourning v. Family Publications Service*, 411 U.S. 356 (1973).

Appended to the foregoing letter was an Attachment A entitled "Statement of Staff of the Division of Special Statutes on Credit Insurance Sales Practices and Section 106(b) of the Truth in Lending Act (Title I of the Consumer

² See National Commission on Consumer Finance *Consumer Credit in the United States*, at 84-85 (1972).

Senator William Proxmire, in a statement released on November 12, 1974, estimated that consumers paid more than \$615 million extra in 1973 for group credit insurance. The overcharges are largely a result of the "reverse competition" which presently exists in this market, and makes it advantageous for creditors to charge the highest legally permissible premium for credit insurance so that they will receive the largest possible loss experience rebate.

³ See, e.g., California Personal Property Broker Law Section 22458.1(b); California Industrial Loan Law, Section 18661(c). The enforcement of those statutes by the California Department of Corporations makes California the only state in which penetration rates for credit life insurance consistently are below 90%. Moreover, the tying of the purchase of insurance to an extension of credit is not entirely free from antitrust implications. Cf., *Fortner Enterprises, Inc. v. United States Steel Corp.*, 394 495 (1969)."

Credit Cost Disclosure Act, Public Law No. 90-321 (1968), 15 U.S.C. 1601, et seq." Set forth below are selected excerpts of the⁴ foregoing Statement.

The following material is offered in support of the Commission's recommendation that the provisions of the Truth in Lending Act dealing with disclosure of the costs of credit life and credit accident and health insurance be amended. Much of the information on which this memorandum is based has been drawn from material gathered in the course of the staff's current investigation of credit insurance sales practices of direct loan finance companies. The opinions expressed are those of the staff, and not of the Commission.

"We are aware that the most common method used to force the consumer to purchase credit insurance is not nearly as obvious as that described by the above complainant. The usual approach is described best in these excerpts from a memorandum of a district manager of a subsidiary of a major national finance company to his five branch managers.

April 27, 1973

Attached is a breakdown of insurance sales for all offices in district _____ by month for the first quarter of 1973.

The statistics, as laid out, are quite clear, and I'm sure that each of you are capable of analyzing the trend in your individual branch.

It is my opinion that taking into consideration total overall sales only two offices in the district are anywhere near satisfactory; these are: (Office 1 and Office 2). The rest of the branches in the district are just going to have to face reality—you are being out sold and out dazzled in your approach to selling insurance by these two offices and, I can assure you, other offices throughout the Region.

I have discussed with both Mr. (X in Office 1), and Mr. (Y) and staff, in (Office 2) their approach toward selling insurance. They both state quite simply regarding life and A & H that they include it automatically on the loan (both types). They only retract or switch after making every attempt to sell the customer on accepting it in the loan as it is. They do not soft pedal it or give the customer a chance to turn it down before it is even written into the loan. Their approach is automatic and positive.

I think we can all safely say it is far easier to leave it in and let the customer insist on having it retracted rather than opening the gate, so to speak, and allowing the sale to slip through our fingers before we have even made a real sale attempt.

I want to make it clear that in regards to the above statements, I'm speaking primarily about life and A & H. Fire insurance sales are another matter.

All of the other offices in the district should pay particular attention to the fact that, for the most part, the trend is adverse and down in your respective branches—meaning that our mental approach to selling insurance is getting weaker. We are giving the customer more and more opportunities to turn it down rather than taking a firmer approach.

There was a time when our credit life sales would have registered 100 per cent, or 99.9 per cent, throughout the region. I feel quite confident that credit life can be maintained somewhere in the area of around 98 per cent. There is ample evidence in (Office 1 and Office 2) and (Office 3) in February, that this can be accomplished.

Health and Accident insurance can be and must be maintained around 90 per cent, and in some cases, obviously, we can even go higher.

* * * * *

The overall importance of insurance sales in relation to our gross profit cannot and should not be underestimated. At the present time the branches are going to receive 35% of all sales. In addition to that, no losses are going to be charged directly to the branch P & L's. They are going to be handled on a higher level, and as I understand it, on a zone level. So it follows.

⁴ The Statement, in a portion of the narrative not excerpted, especially discusses a situation where a bank allegedly required an attorney to "elect" credit insurance in order to get an automobile loan. Since the creditor in that case was not subject to FTC jurisdiction, however, the FTC did not pursue the complaint and confirm the facts alleged.

by maintaining good solid underwriting policies and selling consistently, we can build the profit on the branch level and the zone level as well.

I would like to lay out what I believe are realistic guidelines for the sale of insurance, and I believe by the end of the second quarter, we should be hitting in each branch very near to these figures.

Credit Life 98%, Health and Accident 90%, Fire 60%.

As you can see, much discussion and emphasis must be given to this area by management to insure that sales are on an upswing and this trend is reversed by the end of June.

Immediately upon receipt of this I.O.C., all managers are to hold a staff meeting regarding insurance sales only. I want a copy of what is discussed at this meeting and what steps you, as a manager, are going to take to insure that insurance sales are brought back into line.

The consumer, especially a consumer who has an immediate need for a loan, who is confronted with this tactic will often purchase insurance without question, simply assuming that the insurance is a part of the loan. The tactic is an effective one since most consumers will not know that they had an option and, thus, will complain to no one.

It is our tentative conclusion that these tactics are in wide use and that they are responsible for the high level of credit insurance sales which pervade the direct loan market. The effectiveness of this type of salesmanship is reflected in the State by State penetration rates (that is the percentage of all loans made on which credit insurance is sold) for credit life insurance sales which the Division has obtained from various major finance companies.

For example, Table 1 reflects penetration rates obtained from four major national companies (Company A, Company B, Company C and Company D) for a two month period of 1973 in selected states. Additional rates obtained for the entire year show that the penetration rates for these two months are representative of those for the entire year.

BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C.

HON. WILLIAM PROXMIRE,
*Chairman, Subcommittee on Financial Institutions,
Committee on Banking and Currency,
U.S. Senate,
Washington, D. C.*

DEAR MR. CHAIRMAN: This is in further reference to your letter of August 14, 1967, requesting information and comments concerning tie-in arrangements between banks and credit life insurance companies.

In accordance with my letter of August 30, 1967, to you, the Federal Reserve Banks were requested to develop information concerning situations as to which they were familiar relevant to the sale of credit life insurance by or through State member banks in connection with their lending operations.

From the information received from the Federal Reserve Banks, the Board's staff has prepared a report summarizing, briefly, State and Federal laws and regulations dealing specifically with the sale of credit life insurance by banks and bank-affiliated persons. The report also summarizes the information so received concerning certain practices in the sale of credit life insurance by banks, the incidence of banks requiring credit life insurance as a condition to making consumer loans, and the existence of practical alternatives to purchasing such insurance from bank-related insurers. It is hoped that the staff report, a copy of which is enclosed, will be of assistance to you.

As you will recall, your Truth in Lending bill, S. 5, as passed by the Senate last June, requires the itemization of charges for credit life insurance, and, if so itemized and disclosed by the creditor to the customer, such charges need not be included in the "finance charge." Governor Robertson supported this treatment of the matter when he testified before your Subcommittee on May 10, 1967, and before Mrs. Sullivan's Subcommittee on August 7, 1967. However, the bill recently reported by the House Committee on Banking and Currency (H.R. 11601) would include such charges in the "finance charge."

While the Board at this time is not prepared to recommend additional legislation as mentioned in your letter, the following comments may be of interest.

Insuring the life of a debtor for the benefit of his creditor, so as to make payment certain if the debtor dies, is a practice which may benefit both the borrowers and lenders. Lenders have learned that credit life insurance can be a potent factor in attracting borrowers and can create good will. When an insured borrower dies his obligation is discharged through the insurance and need not be collected from his estate. Moreover, an individual who desires a personal loan may have no security to offer other than his earning power, which death terminates. As a result, sound lending decisions may frequently turn on whether such coverage is provided.

Credit life insurance in force has, in the last twenty years, increased from coverage of 4 per cent to 85 per cent of all consumer debts. Although this rapid growth in such a relatively short period of time may have been accompanied by abuses, this does not necessarily indicate a need for Federal legislation that would single out banks from all other lenders. Rather, it is the Board's view that any proposed remedial legislation should focus on credit life insurance as it affects the lending industry as a whole. Determination as to whether legislation is needed, and the terms of such legislation, should await conclusion of the Hart Subcommittee's investigation and issuance of that body's report and recommendations.

In view of the interest in this matter expressed recently by Chairman Patman, we are forwarding to him copies of this letter and our staff report.

Sincerely yours,

WM. MCC. MARTIN, JR.

REPORT ON THE SALE OF CREDIT LIFE INSURANCE BY OR THROUGH BANKS IN CONNECTION WITH THEIR LENDING OPERATIONS

I. Laws and regulations dealing specifically with the sale of credit life insurance by banks, their officers, or affiliated companies in connection with the banks' lending operations

A. STATE LEVEL

Most States do not have statutes or administrative regulations either authorizing or prohibiting the sale of banks of credit life insurance in connection with their lending operations. As far as can be determined, only New York, New Jersey, and Massachusetts give banks specific statutory authority to sell credit life insurance.¹ Conversely, only 14 States were found to have statutes prohibiting banks from acting as agents for the sale of life insurance. In some jurisdictions, this prohibition is absolute;² in others, the prohibition is limited to cities where the population is in excess of a stated figure (usually 5,000).³ In some States, the prohibition against acting as agent for the sale of life insurance specifically applies to banks, while in others, the prohibition applies to all corporations which, of course, include banks.

In jurisdictions where banks are prohibited from selling insurance, officers, employees, and other bank affiliated persons (such as directors' agencies) usually act as agent for the sale of credit life insurance. The bank does not share in the commission or fees earned by such agent. In Massachusetts, however, where banks are permitted to sell credit life insurance, bank affiliated persons are prohibited from obtaining a commission or fee for any credit life insurance offered to the debtor.

While most States have some laws or administrative regulations regarding credit life insurance,⁴ and over thirty have enacted variations of the "Model

¹ Statutory authority given to banks to sell credit life insurance: Massachusetts [ALM ch. 167 § 56 B], New Jersey [N.J.S.A. §§ 17:9A-70.1, 17:9A-70.2], and New York [Banking Law § 108.4(c) (iv)].

² Absolute prohibition against banks acting as agent for the sale of life insurance: Connecticut [Gen. Stat. § 36-60], Hawaii [R.L. § 178-22.5], Kansas [articles of incorporation], Nevada [N.R.S. § 662.190], New Mexico [articles of incorporation], Oklahoma [articles of incorporation], Texas [Ins. Code Art. 21.05], Wisconsin [W.S.A. § 209.04; 43 Op. Atty. Gen. 181 (1954)]; and Wyoming [articles of incorporation].

³ Prohibition, in cities where population is in excess of certain figure, against banks acting as agent for the sale of life insurance: Arkansas [Ark. State. Ann. §§ 66-2810, 66-2811], California [Financial Code § 1208], Colorado [CRS § 14-3.1(2)], Nebraska [R.R.S. § 44-392], and Washington [RCWA § 30.08.140].

⁴ As far as can be determined, Delaware and Missouri are the only States without statutes or administrative regulations pertaining to credit life insurance.

Act for the Regulation of Credit Life Insurance and Credit Health and Accident Insurance,"⁵ such laws are invariably part of the State's insurance code and apply equally to all institutional lenders, rather than to banks in particular.

B. FEDERAL LEVEL

Section 5136 of the Revised Statutes (12 U.S.C. 24) provides, in part, that "Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by [a national bank] . . . for its own account of any shares of stock of any corporation." This statutory prohibition is applicable also to State member banks by virtue of paragraph 20, section 9, of the Federal Reserve Act (12 U.S.C. 335). Section 5136 provides no exception for insurance company stock, nor does any other Federal statute specifically permit the purchase of such stock by a member bank. However, a bank and an insurance agency⁶ may become affiliated through common ownership of their stock, and under section 4(c) (8) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c) (8)), a registered bank holding company is permitted to own shares of any company all the activities of which are of a "financial, fiduciary, or insurance nature and which the Board [after formal hearing] * * * has determined to be so closely related to the business of banking * * * as to be a proper incident thereto * * *". (emphasis added.)

In all proceedings under section 4(c) (8) of the Bank Holding Company Act, the Board has conditioned favorable determination upon, among other factors, receiving satisfactory assurances that the non-banking subsidiary to be acquired would have sufficient expertise and financial resources profitably, and without undue risk to the holding company and its subsidiary banks, to engage in the proposed activities.

II. Practices noted in the sale of credit life insurance by banks, their officers, or affiliated organizations in connection with their lending operations

Most of the Federal Reserve Banks reported that no specific situations had come to their attention involving questionable practices in the sale of credit life insurance by banks, their officers, or affiliated organizations in connection with loans by the banks. However, the information received from the Reserve Banks disclosed some situations that may be of interest.

A partnership, which acquired stock control of the bank and was managing the bank's operations and receiving fee for its services, has taken over the business of providing credit life insurance coverage for the bank's loans.

A bank was experiencing noticeable losses in small, unsecured loans. Upon further investigation it was discovered that the loan officer seldom turned down a loan application because he felt that they were "protected" by credit life insurance coverage. This insurance was sold by a director of the bank who operated an insurance agency across the street from the bank's premises.

⁵ The following are most, if not all of the States which have enacted, with variations, the "Model Act for the Regulation of Credit Life Insurance and Credit Health and Accident Insurance" which was promulgated by the National Association of Insurance Commissioners: Alaska [Alaska Statutes §§ 21.57.010 to 21.57.170], Arizona [A.R.S. §§ 20-1601 to 20-1616], Arkansas [Ark. Stat. Ann. §§ 66-3801 to 66-3819], California [Insurance Code §§ 779.1 to 779.25], Connecticut [Gen. Stat. of Conn. §§ 38-249 to 38-261], District of Columbia [D.C. Code §§ 35-1601 to 35-1612], Florida [F.S.A. §§ 627.0700 to 627.0709], Georgia [Ga. Code Ann. §§ 56-3301 to 56-3312], Idaho [Idaho Code §§ 41-2301 to 41-2316], Illinois [S.H.A. ch. 73 §§ 767.51 to 767.65], Indiana [Burns Stat. Ann. §§ 39-5601 to 39-5614], Maine [M.R.S.A. Tit. 24 §§ 1201 to 1214], Michigan [Mich. Stat. Ann. §§ 24.568(1) to 24.568(24)], Montana [Rev. Codes §§ 40-4201 to 40-4217], Nebraska [R.R.S. §§ 44-1701 to 44-1713], Nevada [N.R.S. §§ 690.310 to 690.450], New Hampshire [R.S.A. §§ 408-A: 1 to 408-A:15], New Jersey [N.J.S.A. §§ 17:38A-1 to 17:38A-15], New Mexico [N.M.S.A. §§ 58-26-1 to 58-26-15], New York [Insurance Regulations §§ 185.1 to 185.11], Ohio [Page's Rev. Code Ann. §§ 3918.01 to 3918.99], Oregon [ORS §§ 739.565 to 739.620], Pennsylvania [P.S. Tit. 40 §§ 1007.2 to 1007.15], Rhode Island [Gen. Laws §§ 27-30-1 to 27-30-17; §§ 27-31-1 to 27-31-18], South Dakota [S.D.C. 1960 Supp. §§ 31-36A 01 to 31.36A 14], Texas [Insurance Code Art. 3.53], Utah [Utah Code Ann. §§ 31-34-1 to 31-34-15], Vermont [U.S.A. T. S. §§ 4101 to 4115], Virginia [Va. Code §§ 381-482.1 to 381-482.16], Washington [RCWA §§ 48.34.010 to 48.34.010], and Wyoming [W.S. §§ 26-151.1 to 26-151.15].

⁶ While affiliation between banks and insurance companies occur occasionally, interrelationships between banks and insurance agencies are, by far, more common.

While there was no evidence that the director was splitting commissions with the loan officer, the other directors were not aware of this arrangement.

In a State where banks are not permitted to sell insurance, the principal loan officer was selling credit life insurance as agent, in a personal capacity. It was evident that the commissions influenced the terms of the loans. This officer is no longer connected with the bank.

In a State where banks are not permitted to sell insurance, the president of the bank had been selling credit life insurance, in a personal capacity, on nearly all of the bank's loans. The commissions from these loans constituted an important supplement to his salary.

In addition to the above-mentioned situations reported by the Federal Reserve Banks, it is possible that abuses, common to all varieties of lenders, might also be practiced by banks.

Where a borrower, covered by a bank's policy of group credit life insurance, discharges his indebtedness prior to its maturity, a refund of the "unearned" part of the premium or fee paid by the borrower should be forthcoming. However, in some situations it is retained by the lender rather than paid or credited to the borrower. Although the Model Act contains a provision which purports to cure this abuse, variations from State to State in the wording of this provision may permit the continuation of this practice. For example, whereas the version enacted by New York [Banking Law § 108.4(c) (1) and Insurance Regulations § 185.8] provides for the refund of unearned premiums to be "paid or credited promptly to the debtor," in Texas [Art. 3.53 § 8], Arizona [§ 20-1611], and elsewhere, the recipient of the unearned premium is designated only as "the person entitled thereto." This wording could permit a lender to provide, in its contract with the insurer, that any such unearned premium be retained by the lender, rather than refunded to the debtor.

Most versions of the Model Act contain provisions to the effect that when credit insurance coverage is required as a condition to a loan or as additional security, the debtor shall have the option of satisfying such requirement with existing policies, or by procuring the required insurance coverage elsewhere. However, because of the inferior bargaining position of the debtor, he may be susceptible to the loan officer's "suggestions" concerning choice of coverage, premium rates, insurer and agent. As a result, the debtor easily may receive the impression that his loan application may be more favorably considered if he follows such suggestions.

The Model Act's provision that the amount charged the debtor by the lender cannot exceed the amount of actual premiums charged the lender by the insurer has not prevented the lender from receiving, if justified by claims experience, a premium refund, dividend, or retrospective rate credit. In the absence of appropriate regulation of credit life insurance, premium rates tend in many instances to be set at levels determined by the rate of return to the creditor (in the form of such "allowances") instead of on the basis of reasonable cost. Such "reverse competition" results in insurance charges to debtors which are unreasonable in relation to the benefits thereby provided to them.

III. Requirement of credit life insurance as a condition of making consumer loans; practical alternative to purchasing such insurance from bank-related insurers where insurance is required

The extent to which credit life insurance is required as a condition for making consumer loans varies from State to State and from bank to bank. It is understood that this is one of the matters on which Senator Hart's Subcommittee has developed comprehensive data. The information received from the Federal Reserve Banks disclosed that the requirements of credit life insurance for direct, unsecured, installment consumer loans exists in one or another of the following patterns:

(1) Credit life insurance covers all such loans; the charge is "built-in" to the total finance charges and is not disclosed as a separate identifiable cost to the borrower.

(2) Credit life insurance is required on all such loans; solicitation occurs after the decision to grant the loan is made. The borrower has the option of furnishing existing policy protection or obtaining coverage elsewhere.

(3) Credit insurance is not required unless the existence of insurance is a significant factor in granting the loan. As in (2), above, the borrower has the option of furnishing existing policy protection or obtaining coverage elsewhere.

(4) Credit life insurance is not required; it is made available by the bank as a service, at no separate cost to the borrower, but no reduction is made where he does not want the insurance. The total finance charge is usually set so as to defray the cost to the bank.

(5) Credit life insurance, while not required, is considered pretty much part of the "package" to which installment borrowers have become accustomed in large city banks. In small banks, however, the decision to purchase credit insurance is more consciously made.

Where the cost of credit life insurance covering direct unsecured installment consumer loans constitutes an identifiable charge, and where credit insurance is required as additional security for the making of a secured loan, most versions of the Model Act provide that the debtor must have the option of furnishing the required insurance through an existing policy or of obtaining the coverage elsewhere than through the lender.

Such alternatives, however, may not be practical. In the first place, most insurers who specialize in writing group credit life insurance use banks and other lenders as their outlets, bypassing the ordinary insurance agent. Secondly, in the typical credit insurance transaction, the borrower is not primarily interested in the insurance; the amount of premium is small in relation to the balance of the transaction, the coverage is readily available only through the lender, and there is no evidence of the existence of any competition between lenders as to the insurance charge. Under these conditions, the borrower could not be expected to determine the value of the insurance to himself. He has little incentive to "shop" for this minor element of the total cost of the transaction. Together with the loan officer's "suggestions" mentioned above in Part II, this would seem to eliminate any practical alternative to obtaining coverage through the lender with whom one is negotiating a loan.

Appendix 8

CHRONOLOGY OF PROCEEDINGS SINCE 1970 CONCERNING BANK HOLDING COMPANY ENTRY INTO THE RETAIL INSURANCE INDUSTRY

<i>Date</i>	<i>Event</i>
December 1970-----	1970 Amendments to the Bank Holding Company Act became law.
January 1971-----	Federal Reserve Board proposed rule naming certain activities as "closely related" to banking.
February 1971-----	Comments were due on proposed rule; formal hearing requested.
May 1971-----	Limited informal hearings.
Aug. 10, 1971-----	Rule promulgated [§ 225.4(a)(9)], which names as insurance agency activities "closely related", and directly related".
Aug. 24, 1971-----	Rule promulgated [§ 225.4(b)(3)], without notice or hearing or comment, which held that a bank holding company engaging de novo in insurance agency activities named in the regulation meets the public interest test in all cases.
September 1971-----	Court review sought of Aug. 24, 1971 regulation [§ 225.4(b)(3)].
October 1971-----	First opposition and request for hearing filed by IIAA in response to specific bank holding company application.
December 1971-----	Aug. 24, 1971, regulation [§ 225.4(b)(3)] suspended; new regulation proposed which would have created "presumption" that de novo entry meets the public interest test.
February 1972-----	Comments were due on December 1971 proposed regulation; formal hearing requested.

<i>Date</i>	<i>Event</i>
September 1972-----	Federal Reserve Board, without notice or hearing or comment, issued a detailed interpretation [§ 225.128] naming what insurance is included in its Aug. 10, 1971, regulation [§ 225.4(a)(9)].
October 1972-----	Court review sought of the September 1972 interpretation [§ 225.128].
January 1973-----	IIAA brief filed in the Court of Appeals (D.C. Cir.).
March 1973-----	Federal Reserve Board ordered formal hearings on 22 applications to engage in insurance agency activities; formal hearings are to start the first week of April and to be completed by the end of May.
April 1973-----	Federal Reserve Board's counsel advised Court of Appeals (D.C. Cir.) that September 1972 regulation was only tentative and that matters covered therein were issues in the formal hearing, and that the permissibility of the activities under the statute was an issue in those proceedings.
June 1973-----	Federal Reserve Board rules, on interim motion, that statutory issues cannot be raised before the administrative law judge.
June 1973-----	Three weeks of formal hearings held on 7 applications (FRB Docket Nos. IA-3, 6, 7, 8, 10, 12, and 13).
July 16, 1973-----	Formal hearing held with respect to Worcester Bancorp application to engage in the sale of credit life, credit accident and health and mortgage redemption insurance (FRB Docket No. IA-1). (IIAA was not a party to this proceeding).
Sept. 7, 1973-----	Administrative Law Judge issued his recommended decision in Worcester case (FRB Docket No. IA-1).
Nov. 9, 1973-----	Administrative Law Judge issued his recommended decision in Florida cases (FRB Docket Nos. IA-3, 6, 7, 12, and 13).
Jan. 14, 1974-----	Administrative Law Judge issued his recommended decision in Georgia case (FRB Docket No. IA-8).
Jan. 28, 1974-----	Federal Reserve Board approved the application in the Worcester case (FRB Docket No. IA-1).
Feb. 7, 1974-----	Administrative Law Judge issued his recommended decision in Alabama bank holding company case (FRB Docket No. IA-10).
July 3, 1974-----	Federal Reserve Board approved the application in the Alabama case (FRB Docket No. IA-10).
July 26, 1974-----	IIAA appealed the decision in the Alabama case to the Fifth Circuit.
Sept. 5, 1974-----	Federal Reserve Board approved the application in the Georgia case (FRB Docket No. IA-8).
Oct. 4, 1974-----	IIAA appealed the decision in the Georgia case to the Fifth Circuit.
July 14, 1975-----	Federal Reserve Board approved the application in the Florida cases (FRB Docket Nos. IA-3, 7, 12, and 13).
Aug. 13, 1975-----	IIAA appealed the decisions in the Florida cases to the Fifth Circuit.
Sept. 22, 1975-----	Federal Reserve Board issued revised decisions approving the applications in the Florida cases (FRB Docket Nos. IA-3, 7, 12, and 13).
Oct. 24, 1975-----	Fifth Circuit approved IIAA's motion to stay proceeding in the Florida cases pending the outcome of the Alabama and Georgia cases.
Nov. 10, 1975-----	Oral argument was held before the Fifth Circuit in the Alabama and Georgia cases. The decisions of the court are pending.

Appendix 9

INSURANCE ACTIVITIES THE FEDERAL RESERVE BOARD HAS FOUND TO BE
"CLOSELY RELATED" TO BANKING

A wide variety of insurance agency activities have been approved by the Federal Reserve Board pursuant to Section 225.4(a) (9) of Regulation Y, 12 C.F.R. § 225.4(a) (9), as interpreted by the Board. Indeed, most limitations placed upon such activities by the Board appear to be based on the Board not yet having authorized the activity rather than an affirmative determination that specific insurance agency activities are *not* permitted for bank holding companies. This requires, in effect, perpetual review of Board actions.

The applications made to the Board, and the approvals granted, generally tend to fall into categories which track the language of the subdivisions of Section 225.4(a) (9), even though such section is rather general. The categories approved by the Board (with the specific lines of insurance permitted within each category) are as follows:

1. *Any Insurance for the holding company and its subsidiaries.*—In addition to insurance covering assets and property, this category also has been held to include group insurance coverage for all employees of the holding company and subsidiaries, whether premiums are paid by the employer or the employee.¹

2. *Insurance related to an extension of credit or other financial service.*—Included in this category are the following lines of insurance: Insurance against fire, theft and other perils; comprehensive insurance; collision insurance; marine insurance; boiler and machinery insurance surety bonds;² homeowners' insurance; and liability insurance.

In addition to being able to be sold in connection with ordinary loans to business and consumer borrowers, these lines are also able to be sold in connection with other financial transactions, such as leasing, mortgage servicing, and inventory financing. The insurance must be on property in which the bank holding company has a security interest, services or acts as lessor (including other coverages packaged therewith).

3. *Insurance providing loan or repayment funds in the event of inability of the borrower to repay.*—Included in this category are: credit life insurance; credit accident and health insurance; and, mortgage redemption insurance.

4. *Insurance sold as a convenience to the purchaser.*—This category includes *any* line of insurance offered by a general insurance agency. Approval of insurance sales in this category is conditioned upon the premium income derived from "convenience" sales being such that it does not constitute a "significant portion" of the aggregate insurance premium income of the holding company from the sources of insurance referred to above. Aside from this limitation on the amount of premium income, there is no limitation on the lines or coverages which may be offered by the holding company and its subsidiaries under this category.

5. *Insurance in communities having a population of less than 5,000.*—In this category holding companies or their subsidiaries are permitted to operate general insurance agencies in communities with populations of less than 5,000 persons, with no limitation on premium income or coverages offered. These communities need not be rural or isolated, but may be smaller communities within a standard metropolitan statistical area (SMSA) containing one or more large population centers.³

6. *Insurance sold because other sources are inadequate.*—The Board's Rules provide for this category, but no authorizations have been granted hereunder.

¹ See *The Alabama Financial Group, Inc.* 39 Fed. Reg. 25548 (1974).

² Including bid bonds, subdivision bonds and completion or performance bonds.

³ For example, the Federal Reserve Board approved the application of The Alabama Financial Group, Inc. (now Southern Bancorporation) to sell insurance in Hoover, Alabama, a community of less than 5,000 persons which is located within the Birmingham, Alabama SMSA. See *The Alabama Financial Group, Inc.* 39 Fed. Reg. 25548 (1974). See also 12 C.F.R. § 225.4(a) (9) (iii) (1).

Appendix 10

DECISIONS BY THE ADMINISTRATIVE LAW JUDGE AND THE FEDERAL RESERVE BOARD
CONCERNING THE APPLICATION OF FIRST HOLDING CORP. OF ATLANTA, GA., TO
ENGAGE IN INSURANCE AGENCY ACTIVITIES

FEDERAL RESERVE SYSTEM—FIRST NATIONAL HOLDING CORP.

Order Approving Application to Engage in Certain Insurance Agency Activities

First National Holding Corporation, Atlanta, Georgia, a bank holding company within the meaning of the Bank Holding Company Act, has applied for the Board's approval, under § 4(c) (8) of the Act and § 225.4(a) (9) of the Board's Regulation Y, to engage in certain insurance agency activities through a division of Applicant's wholly-owned subsidiary, Tharpe and Brooks, Inc., Atlanta, Georgia. Applicant proposes to act as an insurance agent or broker in respect to the following types of insurance:

1. Any insurance for Applicant and its subsidiaries.
2. Any insurance required by lender to protect the value of an asset being financed by Applicant or its subsidiaries such as autos, boats, mobile homes, campers, and appliances. Insurance sold in this regard would be: a. fire, theft and other perils; b. comprehensive; c. collision; d. marine; e. liability; and f. property floaters.
3. Any insurance required by Applicant or its subsidiaries to protect the value of inventory being financed by Applicant or its subsidiaries. Insurance sold in this regard would be: a. property coverage; b. business interruption; and c. liability.
4. Any insurance required to protect the value of an asset being leased where Applicant or its subsidiaries are the lessors. Insurance sold in this regard would be: a. property coverage and b. liability.
5. Any insurance required by Applicant or its subsidiaries to protect the value of real estate being financed by Applicant or its subsidiaries, whether acting as principal or agent. Insurance sold in this regard would be: a. property coverage; b. loss of rents; c. liability; d. homeowners; and e. performance bonds.
6. Any insurance required by Applicant or its subsidiaries to protect the value of business equipment being financed by Applicant or its subsidiaries. Insurance sold in this regard would be: a. property coverage and b. liability.
7. Any insurance on the life or health of a borrower or lessee of the Applicant or its subsidiary where the Applicant or the subsidiary is the beneficiary of the insurance. Insurance sold in this regard would be: a. disability income; b. mortgage life; and c. credit life.
8. Any insurance that is otherwise sold as a matter of convenience to the purchaser, such as: a. accident health; b. automobile; c. property; d. casualty; and e. life.

The sale of certain types of insurance is an activity which has been determined by the Board to be closely related to banking (12 C.F.R. 225.4 (a) (9)) and, in general, to offer sufficient public benefits so as to meet the requirements of § 4(c) (8) of the Act.

Notice of the application was published in accordance with § 225.4(b) (2) of the Board's Regulation Y. Objections to the application were filed by certain local independent insurance agencies and by the National Association of Insurance Agents ("NAIA") and the Georgia Association of Independent Insurance Agents ("GAIA"). These parties sought and were granted intervention in the proceeding and requested a hearing thereon.

By Order dated March 6, 1973, the Board directed that a formal hearing be held on the subject application, as well as 21 other pending applications by bank holding companies to engage in certain insurance agency activities before a designated Administrative Law Judge ("Law Judge") (38 Federal Register 6441). In addition to the parties designated above, other parties sought and were granted permission to participate in the proceedings, including the National Association of Life Underwriters ("NALU"), U.S. Fidelity and Guaranty Company ("USF&G"), and the Committee to Preserve Consumer Options ("CPCO") (an association of 28 banking institutions including

most of the applicant bank holding companies in other docketed insurance agency applications then pending before the Board).

Following a prehearing conference on March 27, 1973, a public hearing was held in Atlanta, Georgia, commencing on June 27 and closing on June 29, 1973. A substantial record was developed through testimony and exhibits of the parties to the proceedings and others from the banking and insurance communities, both in support of, and in opposition to, the application.¹ The hearing has been conducted in accordance with the Board's Rules of Practice for Formal Hearings (12 CFR 263).

In a Recommended Decision, the Law Judge concluded that the evidence supported a partial approval of the application and recommended:

(1) That the application be granted with respect to proprietary and employee insurance for Applicant and its subsidiaries and for credit life, health and accident, and mortgage redemption insurance for their customers but denied as to all other forms of insurance in the Atlanta, Georgia area.

(2) That the applications be granted as to insurance agency sales by First South Insurance Agency Division of Tharpe and Brooks, Inc. at its offices located outside of the Atlanta, Georgia, area and to customers of non-banking affiliates of First National Holding Company also located outside the Atlanta, Georgia, area, subject to the restrictions as set forth in Regulation Y § 225.4(a) (9).

(3) That, in those respects in which the application is granted, the authorization be subject to appropriate anticompetition statements to be furnished for execution by customers as part of their insurance applications.

The Board, having considered the exceptions taken to the Recommended Decision by the various parties and the entire record, and having determined that the Law Judge's findings of fact, conclusions, and order, as modified and supplemented herein, should be adopted as the findings, conclusions, and order of the Board, now makes its findings as to the facts, its conclusions drawn therefrom, and its order.

Applicant's only banking subsidiary, First National Bank of Atlanta ("Bank") had deposits of \$1.0 billion representing about 24.5 per cent of total deposits of commercial banks in the Atlanta Metropolitan Statistical Area.² Applicant also controls several nonbanking subsidiaries engaged in such activities as data processing, leasing of personal property and equipment, mortgage banking, factoring, and commercial real estate financing. One of Applicant's nonbanking subsidiaries, Tharpe and Brooks, Inc., was acquired in 1970. This subsidiary is engaged in the activity of mortgage banking and, as of May 31, 1973, serviced loans on property worth \$420 million. Applicant proposes to engage in the above-described insurance agency activities through a division of Tharpe and Books, Inc. and estimates that during the first year of operation this division should generate approximately \$1.5 million in premium income.

The principal issues involved in this application are identical to those considered by the Board in its July 3, 1974, approval of the application of The Alabama Financial Group, Inc. to engage in certain insurance agency activities (39 Federal Register 25548). The Board must determine whether the activities sought to be engaged in by Applicant are: (1) permissible activities within § 255.4(a) (9) of Regulation Y and therefore closely related to banking or managing or controlling banks and (2) whether performance of the proposed activities 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. The Board has previously determined by Regulation (12 CFR 225.4(a) (9)) ("Insurance Regulation") that the following insurance agency activities are closely related to banking or managing

¹ Board counsel participated in the hearing in a nonadversary capacity and took no position with respect to the merits of the application (12 CFR 263.6(d)).

² All banking data are as of December 31, 1972.

³ The Board's Insurance Regulation was adopted after notice of proposed rulemaking and following receipt of comments on the substance of the proposed regulation. The insurance activities authorized by the Insurance Regulation are arguably narrower than those insurance activities authorized by the Board prior to the 1970 amendments to the Bank Holding Company Act. These prior decisions of the Board were referred to approvingly by members of Congress in debate on the 1970 Amendments.

or controlling banks and, in general, that performance of these activities by bank holding companies satisfies the public benefits test of §4(c)(8) of the Act.⁵

(9) Acting as insurance agent or broker in offices at which the holding company or its subsidiaries are otherwise engaged in business (or in an office adjacent thereto) with respect to the following types of insurance:

(i) Any insurance for the holding company and its subsidiaries;

(ii) Any insurance that (a) is directly related to an extension of credit by a bank or a bank-related firm of the kind described in this regulation, or (b) is directly related to the provision of other financial services by a bank or such a bank-related firm, or (c) is otherwise sold as a matter of convenience to the purchaser, so long as the premium income from sales within this subdivision (ii)(c) does not constitute a significant portion of the aggregate insurance premium income of the holding company from insurance sold pursuant to this subdivision (ii);

(iii) Any insurance sold in a community that (a) has a population not exceeding 5,000 or (b) the holding company demonstrates has inadequate insurance agency facilities.

The Law Judge concluded after review of the legislative history to the 1970 Amendments to the Bank Holding Company Act that "the Congress clearly had credit-related insurance agency sales in mind as an enterprise closely related to banking subject, however, to surviving the gamut of a net public benefits test * * *" page 17. The Board concurs with the Law Judge's understanding of the legislative history to this section of the Act and notes that this interpretation formed, in part, the basis for the adoption of the Board's Insurance Regulation. The Board has examined the individual types of insurance that Applicant seeks permission to sell in order to determine whether they come within the terms of the Insurance Regulation and whether their sale by Applicant satisfies the public benefits test.

Applicant seeks to sell under No. (1) above insurance for Applicant and its subsidiaries. Sale of this type of insurance has heretofore been permitted under § 225.4(a)(9)(i) of the Board's Insurance Regulation. Insurance permissible to sell under No. (1) would include insurance for the protection of the employees of the holding company in situations where the employee pays a portion of the premium for such insurance. As the Board noted in its Order referred to above relating to the application of The Alabama Financial Group, Inc., the protection of a bank holding company's employees through group insurance is a distinct benefit to the holding company the same insurance on real property owned by the holding company. Therefore, the Board finds that the sale of insurance for the holding company and its subsidiaries, including group insurance for the protection of employees of Applicant, is a permissible activity under § 225.4(a)(9)(i) of the Insurance Regulation.

Under Nos. (2), (3), (5), and (6) above, Applicant seeks to sell various forms of insurance that protect the collateral that secures an extension of credit by Applicant or its subsidiaries. The Board finds that such coverages are directly related to an extension of credit within the meaning of § 225.4(a)(9)(ii)(a) of the Insurance Regulation. Insurance is essential from the lenders' standpoint to assure that the value of the collateral underlying an extension of credit will not be impaired by physical damage. The evidence of record in this proceeding confirms that the sale of insurance protecting the collateral securing an extension of credit is directly related to such extension of credit.

Applicant also seeks approval under these sections to sell liability insurance with regard to the assets being financed by Applicant or its subsidiaries. It appears from the evidence in this proceeding that liability insurance is generally sold in conjunction with property insurance on collateral securing extensions of credit. The Board has previously determined that where liability insurance is sold as part of a package with property insurance on collateral securing an extension of credit, the sale of such liability insurance is directly related to an extension of credit within the meaning of § 225.4(a)(9)(ii)(a) of the Board's Insurance Regulation. The Board reaffirms that position herein.

Applicant seeks authority under No. 5(d) above to sell homeowners' insurance. This is also a package form of insurance that combines property in-

surance with several other types of coverages and comes within § 225.4 (a) (9) (ii) (a) of the Board's Insurance Regulation. This conclusion is further confirmed by the evidence of record indicating the difficulty of separately obtaining the several types of coverages contained in a homeowner's policy at a price comparable to that for the package. Accordingly, the Board concludes that the sale of homeowners' insurance supports the lending transactions of a bank or bank-related firm in the holding company system when it is sold to borrowers as a means of protecting the collateral in which the bank or bank-related firm has a security interest and is a permissible activity within § 225.4(a) (9) (ii) (a) of the Insurance Regulation.

Applicant requests authority under No. 5(e) above to sell performance bonds. Performance bonds have traditionally been sold as part of a mortgage loan transaction, and in the Board's judgment, there is a direct relationship between the sale of performance bonds and an extension of credit. The Board, therefore, finds that the sale of performance bonds is an activity within § 225.4(a) (9) (ii) (a) of the Insurance Regulation.

The sale of the several types of insurance sought to be sold under 5(a) (c) (d) (e) is also permissible where Applicant or its subsidiaries service mortgages for third parties. A company that services mortgages is usually responsible for obtaining insurance protecting the collateral supporting such mortgages and, thus, the sale of insurance is directly related to the provision of a financial service. Accordingly, the Board finds that the sale of insurance under such circumstances is with § 225.4(a) (9) (ii) (b).

Under No. (4) above, Applicant seeks to sell property and liability insurance which protects the value of assets being leased by Applicant or its subsidiaries. Property insurance protects the interest of Applicant in the assets being leased and, moreover, where liability insurance is sold as part of a package with property insurance, the former also is directly related to the provision of a financial service. Accordingly, the Board concludes that such insurance comes within § 225.4(a) (9) (ii) (b) of the Insurance Regulation since it is directly related to the provision of a financial service by a bank or bank-related firm.

Applicant has applied under 3(b) and 5(b) above for permission to sell business interruption insurance and loss of rent insurance. However, little or no evidence was presented orally, or otherwise, concerning these types of insurance. Accordingly, there is insufficient evidence in this record upon which the Board may determine whether the sale of such insurance is closely related to banking or managing or controlling banks.

Applicant seeks under No. (7) above, to sell credit life, credit accident and health, and mortgage redemption insurance where the Applicant or one of its subsidiaries is the named beneficiary. The Board has previously determined that the sale of these forms of insurance is within § 225.4(a) (9) (ii) (a) of the Insurance Regulation⁴ and reaffirms that determination herein.

Finally, under No. (8), Applicant seeks to sell insurance that is otherwise sold as a matter of convenience to the purchaser. The premium income from sales in this category would not constitute a significant portion of the aggregate premium income from insurance sold in connection with the extension of credit or the provision of other financial services. Convenience sales are expressly permitted by the Board under § 225.4(a) (9) (ii) (c) of the Insurance Regulation. However, the Board does not regard this provision as permitting the entrance by any of Applicant's subsidiaries into the general insurance agency business.

In determining whether a particular activity is a proper incident to banking or managing or controlling banks, the 1970 Amendments to the Act require the Board to "consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, than outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices." The Board, in adopting the Insurance Regulation, found that the

⁴ See Board Order relating to Worcester Bancorp, Inc., (1974 *F.R. Bulletin* 393) and the Board's Order relating to the application of the Alabama Financial Group, Inc. (39 *F.R. Bulletin* 25548).

performance by bank holding companies of these activities authorized by such Regulation satisfied, in general, this public benefits test. Additionally, in considering this application the Board has specifically determined whether performance of insurance activities by this Applicant satisfies the public benefits test.

It is reasonable to anticipate that approval of the subject application will result in a greater convenience to the public. There is evidence in the record that the ability of a borrower to purchase insurance at the same location where he obtains credit is likely to result in savings in time as well as avoiding duplication of information common to both credit and insurance transactions. Although initially Applicant intends to have only one licensed agent at one of the branches of its banking subsidiary, borrowers from other branches and from Applicant's nonbanking subsidiaries can telephone the licensed agent and should be able to complete the insurance transaction at the time the credit is extended. This convenience may well be more apparent in regard to the sale of personal insurance than in the sale of commercial insurance; however, it appears that there is a commonality of information between existing commercial credit and commercial insurance so that convenience factors should be present in this context also. On the basis of this evidence, the Board concludes that consummation of this transaction would provide a greater convenience to the public and that this factor supports approval of the application.

It appears from the evidence of record that Applicant's sale of insurance would result in certain efficiencies. Almost all of the customers of the proposed agency will be referred to the agency by loan officers of Applicant. This should result in the reduction or, perhaps, even elimination of advertising and solicitation expenses. Moreover, there was testimony in the record that Applicant's banking subsidiary encountered problems in obtaining a verification of renewals of automobile insurance. This problem should be eliminated by having an agent affiliated with Applicant responsible for these renewals. There was also testimony that having the various loan officers of Applicant deal with one agent employed by Applicant would likely result in efficiencies through the establishment of a common pattern of operations. The Board concludes that such efficiencies taken in the aggregate constitute a public benefit and that this factor weighs in support of approval of the application.

It is reasonable to anticipate that Applicant's entry into the sale of certain insurance policies will result in increased competition among insurance agencies in Georgia. While this increased competition may not result in more than a minimum amount of price competition, it is likely to produce increased competition on the basis of service to customers. For example, the ability to combine credit and insurance in one transaction at one location could be a means by which Applicant would be able to offer effective competition in the sale of these forms of insurance. Additionally, the availability of the financial expertise of Applicant should insure the borrower that he has obtained the proper package of insurance required by the lender. This would bring competitive pressure to bear on other insurance agencies to improve their services. Based on these and other facts and records, the Board concludes that consummation of the subject application would provide public benefits through increased competition.

One of the possible adverse effects which Congress directed the Board to consider in determining whether a particular activity is a proper incident to banking is the danger of undue concentration of resources. There is no credible evidence in this record establishing that consummation of this transaction would result in an undue concentration of resources. Applicant projects that during the first year of operation after approval of this application the insurance agency division of Tharpe and Brooks, Inc. will generate about \$1.5 million in premium income. Even assuming that Applicant's premium income would be substantially greater than this projection, premium income of such volume cannot be viewed as an undue concentration of resources of the magnitude which Congress visualized in adopting § 4(c) (8) of the 1970 Amendments. Nor, considering the numerous banking alternatives available in Atlanta, is it likely that Applicant will be able to dominate the insurance agency business through the sale of such insurance by its banking

subsidiary. Accordingly, the Board concludes that Applicant does not possess sufficient market power to deny its entry into the insurance agency field.

Another possible adverse effect which the Congress directed to the Board to consider in any § 4(c)(8) application is the danger of decreased or unfair competition. Intervenor vigorously contested this application on such grounds. Their argument was that permitting Applicant to sell insurance would lead to coerced or voluntary tying⁵ of insurance to extensions of credit by Applicant. The incidence of tying would allegedly be particularly widespread in times of "tight money." It appears that the Law Judge was concerned with such a possibility and accordingly recommended that Applicant not be permitted to sell several types of insurance in the Atlanta area where Applicant's banking subsidiary held approximately 24.5 per cent of the total deposits in commercial banks.

However, the evidence of record contains no specific instances of a tying arrangement resulting from either coerced or "voluntary" tying. In fact, a witness for the intervenors admitted that he knew of no attempt by Applicant to coerce borrowers to purchase insurance. On the other hand, there was testimony by Applicant's witnesses that insurance was not discussed with borrowers until after the loan transaction was closed. This would appear to alleviate any potential danger of voluntary tying. Moreover, it is clear that coerced tying is forbidden by § 106 of the Bank Holding Company Act and, under certain conditions, by provisions of the antitrust laws. For these reasons, in addition to Applicant's commitment not to coerce borrowers to buy insurance, the Board concludes that the dangers of coerced tying are not substantial and should not bar Applicant's sale of insurance in the Atlanta area.

Further evidence that would indicate that the amount of voluntary tying that would arise from the ability of Applicant to sell insurance would not be substantial include testimony that Applicant, through its subsidiary Tharpe and Brooks, Inc., had been able to sell insurance to only approximately 13.5 per cent of the mortgage borrowers of this firm. It appears that an even lower percentage of automobile loan borrowers from Applicant also purchased automobile insurance from the Applicant's insurance agency. Additionally, as noted above, there are numerous alternative commercial banks in Atlanta to which a borrower may turn. There are also many nonbank lenders which compete in the Atlanta area. Borrowers can obtain automobile loans from sales finance companies, personal loans from consumer finance companies and credit unions, and mortgage loans from savings and loan associations and mortgage bankers. Considering these nonbank sources of credit together with the banking alternatives in Atlanta, the Board concludes that the sale of certain forms of insurance by Applicant will not create a possible danger of voluntary tying borrowers of their insurance needs to their loans. Accordingly, the Board does not believe that Applicant should be foreclosed from selling insurance in Atlanta or that the public should be denied the greater conveniences, efficiencies, and increased competition that are likely to result from approval of the application. It is the Board's judgment that consummation of the proposal would not result in decreased or unfair competition.

The Law Judge recommended in his decision that "appropriate statements be included in all insurance application forms furnished by affiliates of the Applicant, in bold type above the borrower's signature, to the effect that the customer understands the placement of such insurance is not offered as a condition to the grant of credit, nor is an inducement therefor * * *". The Board notes that similar statements are likely to be included in all Truth in Lending disclosures made pursuant to the Board's Regulation Z with respect to credit life, accident and health, or loss of income insurance and it finds that the evidence in this record is not sufficient to otherwise require such language.

The Law Judge also recommended as a condition of approval that language be added to insurance application forms indicating that "similar insurance, not necessarily naming the lending institution as beneficiary, may be obtained from independent agents or in lieu thereof, that existing insurance owned by the debtor may be assigned to the bank" (page 20). The Board has not

⁵ Voluntary tying results not from any coercion placed on the borrower by the lender but rather from the borrower's presumed desire to enhance the probability of obtaining a loan.

required this specific condition before; it notes that a similar statement will most likely be involved in appropriate Truth in Lending disclosures under the Board's Regulation Z with regard to casualty and liability insurance, and it believes that the evidence in this record is insufficient to demonstrate a public need for such a requirement beyond that reflected in Regulation Z.

Finally in passing on an application under § 4(c)(8), the Board is required to consider whether conflicts of interests or unsound banking practices might arise from Applicant's entry into the insurance agency business. There was no evidence in this record to indicate such possibilities and the Board concludes that consummation of the transaction would not result in either conflicts of interests or unsound banking practices.

Subsequent to the Law Judge's decision in this case, legislation was passed by the Georgia legislature which arguably bore upon this application. Copies of such legislation, § 56-322 of the Georgia Code, were provided the parties and they were given the opportunity to comment. The parties' comments have been received, and the Board has considered such legislation and the parties' comments thereto.

In general, § 56-322 would restrict the types of insurance that a bank holding company could sell in Georgia. Applicant and CPCO have argued that such legislation by its terms does not apply to Applicant. The Board agrees with this contention since 1(d) of § 56-322 provides that any officer or employee of a bank holding company licensed to sell insurance in Georgia on January 1, 1974, and operating continuously since that date is not subject to the restrictive terms provided for in 1(a) of § 56-322.⁶ The record establishes that Applicant acquired Tharpe and Brooks, Inc. in 1970 and has operated the insurance agency division of the company since then until the present time with appropriately licensed agents. Thus, Applicant appears to come within the exemptive provisions of 1(d) of § 56-322 and the Board concludes that Georgia law does not clearly prohibit the insurance activities in which Applicant seeks to engage.

The Board notes that NAIA has objected to the exclusion by the Law Judge of certain testimony of Mr. Harrison Houghton, a witness of NAIA. The Board, after examining the record concludes that the Law Judge correctly exercised his discretion in refusing to admit this testimony since it was cumulative to other testimony in the record and, moreover, irrelevant to many of the issues involved in this application.

NAIA filed a motion to exclude Board personnel who were involved in this hearing from participating "in the making of the Board's decision" on this application. Since such personnel of the Board did not participate in the decisional process, the issue raised by the motion is moot.

Based on the foregoing and other considerations reflected in the record, the Board has determined that the balance of the public interest factors the Board is required to consider under § 4(c)(8) is favorable. Accordingly, the application is hereby approved subject to the exceptions noted above. This determination is further subject to conditions set forth in § 225.4(c) of Regulation Y and to the Board's authority to require such modification or termination in the activities of the holding company or any subsidiaries as the Board finds necessary to ensure compliance with the provisions and purposes of the Act and the Board's regulations and orders issued thereunder or to prevent evasion thereof. The transaction here approved shall be made not later than three months after the effective date of this Order unless such period is extended for good cause by the Board or by the Federal Reserve Bank of Atlanta pursuant to delegated authority.

By Order of the Board of Governors,⁷ effective September 5, 1974.

THEODORE E. ALLISON,
Secretary of the Board.

⁶ Section 1(d) of § 56-322 reads as follows: "(d) Nothing contained within this Section shall apply to any lending institution, bank holding company, nor to any organization which was a subsidiary or affiliate of either of the foregoing on January 1, 1974, nor to any officer or employee of the foregoing, if on January 1, 1974, such lending institution, bank holding company, subsidiary or affiliate, officer or employee was licensed to operate and was conducting business in conformity with all Federal and State laws applicable thereto, and all Federal and State rules and regulations applicable thereto and who have since January 1, 1974, been in continuous operation."

⁷ Voting for this action: Chairman Burns and Governors Mitchell, Sheehan, Holland, and Wallich. Absent and not voting: Governor Bucher.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DOCKET NO. 1A-8

FIRST NATIONAL HOLDING CORP., ATLANTA, GA.

Application to engage in certain insurance agency activities

Recommended Decision of Paul N. Pfeiffer, Administrative Law Judge.

Recommended:

That application by First National Holding Corporation to enter the credit-related insurance agency business through a non-banking affiliate be approved in those areas outside Atlanta, Ga. where applicant's affiliated operations have not attained a major position, subject to the limitations of Regulation Y, Sec. 225.4(a)(9). Atlanta operations restricted to proprietary and employee insurance and credit life, health, accident and mortgage redemption insurance sales. Appropriate anti-coercion statements required.

Served upon:

J. W. Gibson, Esq., McChesney Jeffries, Esq., Howard O. Hunter, Esq., and Kent E. Mast, Esq., Hansell, Post, Brandon & Dorsey, 3300 First National Bank Tower, Atlanta, Georgia 30303, attorneys for First National Holding Corporation.

Herbert E. Marks, Esq., Thomas E. Wilson, Esq., and John F. Neville, Esq., Wilkinson, Cragun & Barker, 1735 New York Ave., N. W., Washington, D. C. 20006, attorneys for National Association of Insurance Agents, and *Robert R. Richardson, Esq.,* Hurt, Hill & Richardson, William Oliver Building, Atlanta, Georgia 30303, attorney for Georgia Assoc. of Insurance Agents.

James I. Keenan, Jr., Esq., P. O. Box 1138, Baltimore, Maryland 21203, attorney for United States Fidelity and Guaranty Insurance Company.

Lawrence F. Noble, Esq., Metzger, Noble, Schwarz & Kempler, One Farragut Square South, Washington, D. C. 20006, attorney for Committee to Preserve Consumer Options.

Raymond Kit Carson, Esq. and Michael H. Zimring, Esq., Board Counsel, Federal Reserve System, 20th & Constitution Ave., N. W., Washington, D. C. 20551.

I. PRELIMINARY STATEMENT

This proceeding involves an application filed by First National Holding Corporation (Applicant), a single bank holding company whose subsidiaries operate in Georgia, Florida, South Carolina, Mississippi and Alabama, to enter the credit-related insurance agency business through First South Insurance Agency (Agency), a division of one of Applicant's mortgage banking subsidiaries, Tharpe and Brooks, Inc. (T & B) located in Atlanta,¹ Georgia. Applicant's only banking affiliate, First National Bank of Atlanta, (Bank), operates solely in the Atlanta area.

The proceeding is a companion to consolidated Dockets 1A-3, 6, 7, 12 and 13 involving applications by certain bank holding companies to enter the insurance agency business through subsidiaries located principally in Florida. The issues are substantially the same and certain of the testimony introduced in the Florida case has been incorporated in the instant record. The Recommended Decision in the Florida case was issued on November 9, 1973.

The Application is brought under Section 4(c)(8) of the 1970 Amendments to the Bank Holding Company Act, (12 U.S.C. par. 1843(c)(8) as well as pursuant to Regulation Y, Section 225.4(a)(9) [12 CFR 225.4(a)(9)]. The application is opposed by the National Association of Insurance Agents (NAIA), the Georgia Association of Independent Insurance Agents (GAIA), and U.S. Fidelity and Guarantee Company (USF&G). An organization of bank holding companies known as the Committee for the Protection of Consumer Options (CPCO) intervened on behalf of Applicant. Board Counsel

Exceptions, if any, to this Recommended Decision may be filed with the Secretary, Federal Reserve System and served upon all counsel of record within fifteen (15) days from the service date above.

¹ Agency also has offices in Albany, Athens, Augusta, Cobb County, Columbus, Decatur, Macon, and Savannah, Ga.

entered a special appearance but took no position on the merits of the application.

After due notice the application came on for public hearing in Atlanta, Georgia on June 27th, and was concluded on June 29, 1973. After an opportunity was afforded for the filing of opening and reply briefs the case was submitted for recommended decision on October 29, 1973.

II. THE APPLICATION

Holding Company was organized in 1969. Its sole banking subsidiary, First National Bank of Atlanta (the Bank), conducts a general commercial banking and trust business in Fulton and DeKalb Counties, Ga., at 41 offices in the Atlanta area with deposits of \$1,030,000,000 representing 24.3% of the deposits in the SMSA. Total loans at the end of 1972 were \$951,000,000 and operating income \$98,000,000. Bank is the second largest banking institution in Atlanta.

Holding Company owns 22 subsidiaries² operating in various parts of Georgia, South Carolina, Florida, Mississippi, Alabama and Louisiana providing financial services of various kinds including data processing, bank records storage, leasing of personal property and equipment, brokerage and mortgage banking, factoring and commercial and real estate financing.

Among the subsidiaries acquired in 1970 is T & B, which has been in the mortgage banking business since 1947, originating FHA and VA single and multi-family loans for resale to permanent investors and also brokering development and construction loans for commercial projects and single and multi-family housing. As of May 31, 1973 T & B serviced property worth \$420 million and in 1972 closed \$152 million in loans. T & B is also a parent of a wholly owned subsidiary, First South Homeowners Co., Inc., engaged in second mortgage banking in Georgia, Florida, South Carolina and Alabama. Since 1970, T & B has acted as an agent for the sale of mortgage life and accident and health insurance to homeowners served by Holding Company and its subsidiaries. In anticipation of the grant of the current application (effective June 1, 1973) T & B sold all of its insurance agency activities to an independent agency, Tharpe and Associates, Inc.,³ except those sought herein by its division, First South Insurance Agency.

Applicant seeks to obtain permission to sell the following types of insurance: (1) any insurance for Holding Company and its subsidiaries, (2) any insurance required by Bank or its subsidiaries to protect assets being financed such as autos, boats, mobile homes, campers and appliances and including fire, theft and other perils, comprehensive, collision, marine liability and property floaters; (3) any insurance required by Bank to protect the value of inventory being financed by Holding Company or its subsidiaries such as property coverages, business interruption, and liability, (4) insurance to protect the value of assets being leased where Holding Company or its subsidiaries is the lessor such as property and liability, (5) insurance on real estate improvements including property coverage, loss of rents, liability, homeowners and performance bonds, (6) insurance on business equipment being financed such as property and liability, (7) insurance on the life or health of a borrower or lessee of Holding Company or a subsidiary such as disability income, mortgage life, and credit life, (8) insurance that is otherwise sold as a matter of convenience to the purchaser such as accident and health, automobile, property, casualty and life.

The proposed insurance is intended to cover the interest of the lender, and also the borrower to the extent that the borrower requests, and will include in one policy liability as well as property coverage. With respect to life insurance, Applicant will seek to sell only the amount of insurance the lender will require.

² Bank Records Storage Company, Dixie Finance Company, Inc., Dynabank, Fairlane Finance Company, First Atlanta International, First Atlanta Tri-South, First Bank Building Corp., First National Bank of Atlanta, First National Building Corp., First National—Heller Factors, First South Data Processing, First South Financial Corp., First South Homeowners Co., Inc., First South Leasing Company, Kenesaw Finance Co., Gulf Finance Corp. of Mississippi, Lafayette, Inc., London Interstate Bank Ltd., Tri-South Management Associates, Woods-Tucker Leasing Co., and Tharpe and Brooks, Inc.

³ T & B and Tharpe and Associates, Inc. have numerous common officers, directors and stockholders.

The proposed insurance agency will be a centralized operation having offices at 615 Peachtree Street, Atlanta, in the same building as T & B and the second largest branch of Bank. This location is approximately two miles from Bank's main office. The staff will be composed of one licensed agent and five assistants presumably unlicensed. There will be a direct telephone line to each Bank office. It will have access to an IBM 360 computer system of a service bureau which does not specialize in insurance agency operations and will not use direct billing. Applicant will not have access to the credit and investigative files of any of the holding company subsidiaries including the bank. Insurance coverage for a prospective borrower will be arranged by a Bank loan officer or the prospective borrower calling the First South Insurance Agency. Presumably personal contact would have to take place at the Applicant's office. Applicant states that the borrower will not be told about Bank's requirement for insurance to protect collateral for its loan until after approval of the loan and he will be told that he is free to obtain insurance elsewhere.

The Citizens and Southern Holding Co., the largest banking organization in Atlanta with 65 offices and 28.5% of the deposits received authority from the Board in 1969 for a subsidiary to enter the credit related insurance agency business. The subsidiary's president testified during the Florida proceeding⁴ that in 1972 in Atlanta SMSA insurance policies covering 11.1 percent of its parent's automobile loans and 6.8 percent of the homeowners loans were written by that agency. Similarly to the applicant herin C & S Insurance operates by tie-line telephone to the C & S Bank offices. In the case of homeowner's and automobile insurance, policies are usually mailed without other personal contact with the customer. The C & S witness testified that the rates offered are the same as through independent agencies, the principal benefit to the customer being convenience. Also, C & S Insurance expects to generate a higher penetration of its loan customers in the future.

III. LEGISLATIVE DIRECTION

The Congressionally prescribed criteria for consideration of the application are set forth in Section 4(c)(8) of the 1970 Amendments to the Act. These prohibit the acquisition by a bank holding company of ownership or control of any voting shares of any company which is not a bank except:

"(8) shares of any company the activities of which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be 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 shall consider whether its performance by an affiliate of a holding company 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 orders and regulations under this subsection, the Board may differentiate between activities commenced de novo and activities commenced by the acquisition, in whole or in part, of a going concern; . . ."

Prior to 1970, Section 4(c)(8) permitted multi-bank holding companies to acquire shares of companies whose activities would be of a "financial, fiduciary, or insurance" nature and which the Board determined was "so closely related to the business of banking or of managing or controlling banks as to be a proper incident thereto." No regulation was imposed on single bank holding companies some of which promptly proceeded to acquire enterprises in related fields and in turn were acquired by large conglomerates.

In forwarding the proposed amendments to the Congress on March 24, 1969, President Nixon described the current situation as "disturbing" and representing an "erosion of the traditional separation of powers between the suppliers of money—the banks—and the users of money—commerce and industry." The President stated:

"Left unchecked, the trend toward the combining of banking and business could lead to the formation of a relatively small number of power centers

⁴ Consolidated Docket Nos. IA—3, 6, 7, 12 and 13 Tr. 1629—45.

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."

He went on to conclude that:

"Banking must not dominate commerce or be dominated by it."⁵

The principal effect of the 1970 amendments was to subject single bank holding companies to Board regulation. In addition a net public benefits test was imposed on non-bank acquisitions. This standard requires the Board to carefully weigh the degree of public benefits in terms of greater convenience, increased competition or gains in efficiency reasonably expected to be derived from the proposed entrance by a bank holding company into a closely related non-banking function against possible adverse effects such as undue concentration of resources, decreased or unfair competition, conflicts of interests or unsound banking practices. Efforts to broaden the "closely related" test by changing the language to "functionally related" were defeated. On the other hand, a House proposed so-called "negative laundry list" of proscribed non-banking activities including the insurance agency business was deleted in the final version of the Amendments by request of Senate conferees.

Prior to 1970, the Board had interpreted the "closely related" test in the 1956 Act as requiring a "direct and significant connection" between the activities of the proposed subsidiary and those of the holding company affiliated banks. However, in a letter to Congressman Wright Patman, Chairman of the House Banking and Currency Committee, Board Chairman Burns stated that:

"... we do not believe it is desirable to unduly restrict entry by non-bank subsidiaries into markets that are distinct from those served by the subsidiary banks of the holding company. This position may lessen risks of ties in and is consistent with governmental policies to promote competition."

The Chairman then went on to propose the deletion of language from the existing statute "(the business of) banking or of managing or controlling banks" so as to read "banking or managing or controlling banks 'having in mind indicating that a non-bank subsidiary's activity should be related to banking (or managing or controlling banks) generally, rather than to the specific business carried on by the subsidiary banks of the particular holding company involved.'"⁶

On the Senate side Senator Sparkman summarized his views as follows:

"I am convinced that the bill finally agreed to is a good one and will meet this need for flexibility while at the same time preserve ample protection for independent small businessmen to insure that they will continue to flourish."⁷

Senator Sparkman continued as follows:

"... varies only slightly in language and none in substance from the language suggested by Chairman Burns in his letter of November 23rd. ... It frees the Board of the restrictive precedents established under the present Act and it provides that permissible activities may be related to the business of banking generally, rather than perpetuating the concept that such activities must be related to the specific business carried on by the subsidiary banks of the particular holding company involved. Furthermore, it defines 'a proper incident' to banking in very broad terms of various benefits to the public as opposed to possible adverse effects. ... Your conferees are satisfied that the new language will provide the flexibility desired with proper safeguards for the public interest."⁸

Senator Goodell explained his understanding of the philosophy of the bill in the following language:

"I believe the public interest or benefit should be the most important consideration in any case and that the underlying component of the public interest is the maintenance of competition in each local market and the prevention of concentration of economic power. ...

⁵ Cong. Rec. S 20647, December 18, 1970.

⁶ Letter dated November 23, 1970, reprinted at 116 Cong. Rec. (daily ed.) H 41959, December 16, 1970.

⁷ Cong. Rec. S 20638, December 18, 1970.

⁸ Id. S 20640, December 18, 1970.

"In making its decision I feel certain the Fed. must strictly construe our requirement that the petitioning bank holding company show in detail that the acquisition will be in the public interest. Only in this way will they clearly know the consequences of the acquisition and only with this knowledge can a fair, studied judgment be made."

Senator Goodell continued:

"The 'public interest' test is designed to avoid the concentration and misuse of economic power. First, it requires the bank holding company to demonstrate that the acquisition would provide benefits to the public such as greater convenience, increased competition or gains in efficiency. These benefits must outweigh possible adverse effects such as undue concentration of resources, decreased competition, conflicts of interest or unsound banking practices. The conferees make it perfectly clear that expansion into a particular activity should be authorized only where affirmative advantages to be public can be reasonably established. . . ."

"In general, the Fed. has been given the authority to approve acquisitions and make decisions based on the individual facts and circumstances of the applicant bank holding company and its impact in its market area. I believe this flexible, case by case approach is a preferred method of handling the complex questions relating to varied acquisitions."⁹

In discussing his understanding of the intention of the conferees, Senator Bennett cited testimony before the House and Senate Committees by former Board Chairman Martin as follows:

"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 . . . acting as insurance agent or broker or as an insurer in connection with extensions of credit by other subsidiaries of the holding company; . . ."

And Chairman Burns was quoted as follows:

"By weighing the prospects of realizing such benefits against the risks of undesirable consequences, a judgment may be formed about the kinds of services bank holding company subsidiaries should be authorized to provide. In the Board's judgment authorized subsidiaries might well include . . . pertinent insurance functions in connection with services offered by other subsidiaries; . . ."¹⁰

In commenting upon both House and Senate versions of the Bill, the Department of Justice stated as follows:

"The major feature of both versions is the empowering of the Federal Reserve Board to make full use of its economic competence and expertise in financial matters in authorizing the most effective use of the Nation's financial resources and talents."¹¹

With specific reference to the question of "increased competition" and "gains in efficiency," a Department of Justice letter of November 17, 1970, had this to say:

"Innovation in financial fields should be encouraged and it seems particularly desirable to permit bank holding companies to enter other financial markets where competition is weak or where real efficiencies will result."

The letter continued:

"We believe that competitive aspects should play an important role in determining exactly which activities bank holding companies should be authorized to enter in related financial fields. . . . in particular, we consider differentiation between activities commenced *do novo* and activities commenced through acquisition of a going concern to be of prime importance inasmuch as the competitive aspects of a given bank holding company activity may be more substantially affected by the manner of entry than by the nature of the activity itself."¹²

⁹ Cong. Rec. S 20644-5, December 18, 1970.

¹⁰ Cong. Rec. S 20651, December 18, 1970.

¹¹ Cong. Rec. H 41957, December 16, 1970.

¹² Cong. Rec. H 41957, December 16, 1970.

With respect to non *de novo* acquisitions, the Conference Report stated:

"Where a bank holding company enters a market through acquisition of a major going concern, it may not have the incentive to compete vigorously, thereby bringing the possible benefits into play, as it would immediately succeed to what it might consider its fair share of the market. On the other hand, where a bank holding company enters a new market *de novo*, or through acquisition of a small firm, as opposed to acquisition of a substantial competitor, its desire "to succeed in its new endeavor is more likely to be competitive. This legislation specifically emphasizes the importance of the manner in which a bank holding company may enter new activities. Such considerations will be particularly important in the context of expansion by bank holding companies into new geographic markets."¹³

With respect to the "undue concentration of resources" criterion House Banking and Currency Committee Chairman Patman had this to say:

"One of the objects of the law is to keep the banks from acquiring insurance companies for the reasons gone into in the hearings before the Banking and Currency Committee on this bill. A half dozen banks could acquire a half dozen large insurance companies and have enough reserves to actually purchase many of the big profit making businesses in this country. That would create undue concentration of resources which is prohibited under Section 4(c)(8)."¹⁴

With respect to so-called "voluntary" tie-ins, the Conference Report stated:

"Section 106 of the bill, which has come to be known as the anti-tie-in section, will largely prevent coercive tie-ins and reciprocity. But the dangers of 'voluntary' tie-ins and reciprocity are basically structural and must be dealt with by the Board in determining the competitive effects of bank holding company expansion into fields closely related to banking when considering applications under Section 4(c)(8). These will be difficult questions, for assurances of good faith and the intention not to engage in tie-ins and reciprocity by the applicant bank holding companies will largely be irrelevant to the just as serious dangers of 'voluntary' tie-ins and reciprocity. The Board must, in any case, consider these problems in carrying out its responsibilities under the Act."¹⁵

"I regret very much the incident concerning "Mr. X". I based my decision regarding this matter on what I thought to be the best interest of "Mr. X" and the bank. As I indicated to "Mr. X", our bank could not accept the loan unless we were allowed to write the credit life insurance. As I discussed by phone, the primary reason for this request to write the insurance, was because this action increased the return of income on the loan by a good margin. Had our bank been denied this additional income, we could not have approved the loan. Because of the extremely tight credit situation, I feel "Mr. X" would not have obtained the loan elsewhere. Therefore, I believed our bank to be doing "Mr. X" a service by granting this type of loan under these circumstances, with credit as tight as it is at present.

"I can still appreciate and understand your reasoning and regret that "Mr. X" saw fit to cancel his policy with your company. I am hopeful this situation will not occur again in the future."

A fair summary of the legislative history as partially abstracted above indicates that the Congress clearly had credit-related insurance agency sales in mind as an enterprise closely related to banking, subject however to surviving the gamut of a net public benefits test, that a suggestion of Chairman Burns that the "closely related" standard be construed in the broad sense of authorizing entrance by bank-related insurance agency subsidiaries into markets other than those penetrated by the banking affiliates rather than being tied geographically to the banks' areas was endorsed by both Houses, that a preference was expressed in favor of *de novo* entry rather than entry by acquisition of an existing concern, and that the application of the legislative standards in a flexible manner should be entrusted to the Board whose expertise in evaluating financial evidence developed through an adversary public hearing can best determine whether the public benefits reasonably

¹³ H.R. Report No. 91-1747, pp. 17-18, December 15, 1970.

¹⁴ Cong. Rec. H 41961, December 16, 1970.

¹⁵ H.R. Report No. 91-1747, p. 18, December 15, 1970.

expected to be obtained through granting an application under Section 4(c) (8) outweigh the possible adverse effects.

To implement the insurance agency aspects of the 1970 Amendments, the Board *inter alia* promulgated Sec. 225.4(a)(9) of Regulation Y therein describing the following insurance activities as "so closely related to banking or managing or controlling banks as to be a proper incident thereto:"

"(9) acting as insurance agent or broker in offices at which the holding company or its subsidiaries are otherwise engaged in business (or in an office adjacent thereto) with respect to the following types of insurance:

(i) Any insurance for the holding company and its subsidiaries;

(ii) Any insurance that (a) is directly related to an extension of credit by a bank or a bank-related firm of the kind described in this regulation, or (b) is directly related to the provision of other financial services by a bank or such a bank-related firm, or (c) is otherwise sold as a matter of convenience to the purchaser, so long as the premium income from sales within this subdivision (ii) (c) does not constitute a significant portion of the aggregate insurance premium income of the holding company from insurance sold pursuant to this subdivision (ii);

(iii) Any insurance sold in a community that (a) has a population not exceeding 5,000, or (b) the holding company demonstrates has inadequate insurance agency facilities."

IV. FINDINGS AND PRELIMINARY CONCLUSIONS

1. The business of selling credit-related insurance is so closely related to banking or managing or controlling banks as to be a proper incident thereto

NAIA argues that the business of selling insurance covering the borrower's interest as distinguished from the bank's interest in protecting the security for its loan is not directly related to banking or so closely related as to be a proper incident thereto. The argument lacks merit for the bank is primarily interested in the personal and financial security of the borrower and only secondarily interested in the integrity of the loan collateral. In other words, normally banks are primarily interested in repayment of their loan. Sale of collateral such as a car, a house, or commercial asset is clearly less desirable.

Moreover, the final debates in both Houses of Congress on the Amendments to the Bank Holding Company Act of 1970 included references to sales of credit-related insurance as examples of activities closely related to banking. Express reliance was placed on communications from Board Chairmen Martin and Burns to the same effect. Since no distinction was drawn between insurance covering the collateral for a loan and that protecting the financial security of the borrower in the final Congressional discussions of the "closely related" test, it is concluded that the full range of credit-related insurance sales was intended to be included within the "closely related" umbrella subject, however, to findings that the probable public benefits to be derived from approval of a specific application in terms of greater convenience, increased competition and gains in efficiency, outweigh the possible adverse effects of undue concentration of resources, decreased or unfair competition, conflicts of interests or unsound banking practices.

In Section 4(a)(9) of Regulation Y, *supra*, the Board broadly construed the "closely-related" umbrella to include insurance sales directly related to extensions of credit or other financial services by a bank or bank-related firm and also to a limited volume of other insurance sold as a matter of convenience to customers of the holding company and its affiliates.

This interpretation of the statute has been challenged by intervenors. However, such challenge is properly directed to the Board and/or reviewing courts. The Administrative Law Judge is not in a position to pass upon the soundness or legal validity of the Board's interpretation and no opinion on those subjects is expressed herein.

2. The proposed bank affiliated insurance activities can reasonably be expected to result in only minimum increased convenience to the public

The argument that the public will be greatly inconvenienced by one-stop shopping for financial and insurance purposes at any of the Bank's offices in Atlanta is largely outweighed by the fact that the insurance activities will be

concentrated at the Agency office on 615 Peachtree Street. This means that a borrower desiring to obtain insurance through Bank would be obliged to use, or have the bank branch loan officer utilize, the proposed direct telephone line to arrange the coverage. If he desires personal contact with an insurance agent he would have to visit the agency office. In complicated commercial insurance transactions it is likely that some personal consultation would be necessary.

The same customer could use his own business telephone or a public pay telephone for the same purpose or visit a nearby independent insurance agent. There are 105 such agents in the two-mile radius, center-city area of downtown Atlanta.

Agency would be staffed with one insurance agent and five assistants. Considering the expectable volume of business which could be generated by aggressive bank loan officers and applicant's other non-banking subsidiaries, the insurance operation, as proposed, does not portend to be a major convenience to Bank borrowers or customers of Holding Company's non-banking affiliates.

3. Since Agency will not use the direct billing method, it is doubtful that any gains in efficiency will be experienced which are not already being experienced by independent agencies

Despite extensive prodding, Applicant is opposed to using the direct billing technique which large insurance underwriters have devised so as to bill customers directly and pass on to them the benefits of resulting lower agency commissions. Instead Applicant will utilize an outside data processing source.

The direct billing procedure is most prevalent in automobile and homeowners' insurance, particularly on renewal policies. Substantial savings have been experienced in agency expenses reflected in reduced customer premiums.

In summary, while Holding Company may experience some operating efficiency by adding insurance services to its banking and non-banking functions, there is no proof that the customer will benefit in terms of lower cost of insurance coverage. On the contrary Applicant's policy appears to deliberately avoid the most promising technique for insurance customer savings.

4. Approval of the application would probably result in additional units of insurance agency competition but there is no proof that such would result in savings to customers in the form of lower premiums

There is no reliable or probative evidence in this proceeding establishing that approval of the application will result in savings to the insurance customers. There was testimony that pressure would be brought on underwriters to establish favorable rates but no hard evidence was presented of any prospective low premium schedule.

There would be substantial additional competition in the Atlanta insurance agency industry through the 41 bank branch outlets. However, with respect to the banking industry, it is noteworthy that state banks in Georgia do not possess authority to enter the insurance business. Therefore the grant by the Federal Government of this authority would give Applicant an undue advantage over Georgia state banking institutions.

NAIA has argued that Applicant must show a public "need" for its insurance services in order to obtain approval. Public convenience and necessity requirements have been carefully phrased by Congress in the Federal Aviation Act, the Motor Carrier Act, the Federal Communications Act inter alia. No such language surfaced in the Banking Act, as amended, despite some discussion in a House debate approximately one year before the crucial conference on the disagreeing votes of the two Houses (115 Cong. Rec. 33139—Nov. 5, 1969). Consequently, no firm Congressional intent to require a public need test can be found.

5. Entry by the applicant into the insurance agency business would result in an undue concentration of banking-insurance resources to the possible detriment of independent insurance agents in Atlanta

Applicant controls 24.3% of the total deposits in the Atlanta SMSA. In addition, Citizens and Southern controls 28.5% of the same deposits. Together Applicant and C&S control over \$2 billion of deposits in Atlanta. Assuming a loan ratio of 90%, it is apparent that their combined economic power would

represent a formidable threat to the independent agencies by reason of the banks' advantage in terms of a very large built-in clientele of borrowers.

The C&S experienced penetration ratios of 11.1% and 6.8%, respectively, of borrower-automobile and homeowner insurance sales appears modest. There was testimony by an independent agent serving sub-standard risk auto insurance customers that C&S was turning away high risk business. Nevertheless, aggressive salesmanship by both institutions could substantially impact the independent insurance agency business in Atlanta. Applicant alone forecast an agency earning \$4,812,500 in annual premiums. If the application were granted and, as a result, the state of Georgia granted similar authority to its banks, the adverse impact upon the Atlanta insurance agents would possibly be substantial.

On the other hand, with respect to Augusta (Richmond County), Carroll County, Clarke County (Athens), Cobb County (Marietta, Smyrna), Muscogee County (Columbus), Decatur County, Macon SMSA, and Savannah SMSA where Applicant's non-banking subsidiaries operate, there is no evidence of any domination in those markets by Applicant's affiliates.

6. *The record contains evidence of the possibility of tying insurance premiums into negotiations over interest charges in commercial loan transactions*

A witness for Applicant testified that in discussions with regard to the financing of a shopping center, the insurance income that would be involved if the application were granted could affect the lowering of interest rates or other charges and fees under the "package concept." In other words, First South would be "more receptive" to a borrower's last offer if insurance premiums were part of the total package.¹⁶

It is probable that consideration of the "package concept" would also carry over into the ordinary consumer personal loan transaction in the sense that in a period of tight money, Bank would be more willing to grant a loan to a depositor who would voluntarily also offer insurance coverage. Such a practice would not be substantially unlike the common requirement of maintaining compensating non-interest bearing balances in the borrower's account as a condition for obtaining or renewing a personal or commercial loan.

In order to be effective the practice of tying lending with insurance coverage need not be coercive. Voluntary tying by customers in time of tight money or individual financial distress is possible.¹⁷

7. *There is no evidence of potential conflicts of interest or unsound banking practices resulting from approval of the application.*¹⁸

In summary, the application does not offer a reasonable expectation of substantial public benefits except possibly the addition of a well financed multi-office competitor in the Georgia insurance agency industry. As far as the insurance customer is concerned, he already has access to bank affiliated insurance services through Citizens and Southern Bank, First National Bank of Atlanta and C&S together would control more than 50% of all deposits in Atlanta. Assuming a 90% loan ratio, the clientele that could possibly be subtly influenced to divert from Atlanta independent agents is so large that many of the latter could be driven out of business or forced to merge into larger units resulting in decreased competition.

The large direct writers would probably be able to withstand the double-barrelled financial conglomerate competition in Atlanta because of their low cost—low premium operations. But the independent commission agents would have difficulty surviving.

Since these are frequently small enterprises which can be entered with minimum capital and training, the public interest favors their protection and encouragement as reservoirs of economic opportunity for families, youths, veterans and women who aspire to become proprietors or partners rather than mere clerks in large organizations.

¹⁶ Tr. 2331.

¹⁷ In Section 4(c)(8) of the Act, Congress did not require proof that adverse effects such as "tying" be established as "probable" consequences of bank affiliated insurance agency entry. The phrase "possible" adverse effects was employed denoting a lower standard of proof than "probable."

¹⁸ The application does not expressly propose surety bonding which would result in a conflict of interest.

For the foregoing reasons, it is concluded that the reasonable expectation of public benefits to be derived from approval of this application is outweighed by the possibility of adverse effects upon the existing independent insurance agency community in the Atlanta area.

However, in those areas of Georgia where Applicant does not operate a banking subsidiary and where there is no evidence that its non-banking subsidiaries have attained a major position, there would appear to be no objection to its commencing credit-related insurance agency operations. Similarly with respect to Applicant's proprietary and employee insurance needs and credit life, health and accident, and mortgage redemption insurance to which there is no substantial opposition, the application should be granted.

Although an anti-coercion statement that prospective debtors sign at the time loans are negotiated may more likely protect a bank against prosecution for coercive practices than protect the borrower against subtle influences, nevertheless there is a public benefit to be served in at least reminding a customer that he can go elsewhere to procure insurance having no relation to the credit process. Therefore, it will be recommended that appropriate statements be included in all insurance application forms furnished by affiliates of the Applicant in bold type above the borrower's signature to the effect that the customer understands that the placement of such insurance is not offered as a condition to the grant of credit, nor as an inducement therefor; and, in addition, that similar insurance not necessarily naming the lending institution as beneficiary may be obtained from independent agents or in lieu thereof existing insurance owned by the debtor may be assigned to the bank.

Recommended Decision

(1) That the application be granted with respect to proprietary and employee insurance for First National Holding Company and its subsidiaries and for credit life, health and accident, and mortgage redemption insurance for their customers, but denied as to all other forms of insurance in the Atlanta, Ga. area.

(2) That the application be granted as to insurance agency sales by First South Insurance Agency division of Tharpe and Brooks, Inc. at its offices located outside of the Atlanta, Ga. area to customers of non-banking affiliates of First National Holding Company also located outside of the Atlanta, Ga. area subject to the restrictions as set forth in Regulation Y, Sec. 225.4(a) (9).

(3) That in those respects in which the application is granted, the authorization be subject to appropriate anti-coercion statements to be furnished for execution by customers as part of their insurance applications.

PAUL N. PFEIFFER,
Administrative Law Judge.

The CHAIRMAN. Mr. Bobo.

STATEMENT OF JACK E. BOBO, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

Mr. BOBO. Mr. Chairman, my name is Jack Bobo, and I'm a full-time life insurance agent working in Phoenix, Ariz., but also the current secretary of the National Association of Life Underwriters, better known as NALU. I'm accompanied here this morning by Mr. William B. Scher, NALU counsel based here in Washington.

It would be a great temptation to simply say "amen" to the chairman's opening remarks because you have certainly stated very succinctly our own position. However, I would, in a few minutes, like to simply capsulize the statement that we have filed with the committee and ask permission that the full statement be made a part of the record.

The CHAIRMAN. Yes, sir, without objection, that will be done.

Mr. BOBO. Mr. Chairman, I believe it would be helpful to the committee if I were to just take a moment to relate who the people are that I represent in order that you might have a better idea of the perspective with which we view these issues and the context out of which I testify.

The National Association of Life Underwriters is a federation of over 1,000 local and State associations scattered throughout the United States. We have over 135,000 members who are general agents, agents, and general managers engaged in the marketing of all forms of life and health insurance products and they work and live in virtually every community in the United States, from the very smallest hamlet to the largest city, and we very much appreciate this opportunity to come here this morning and speak in support of Senate bill 2721. We are appreciative of the chance because the issues that this bill address are ones that have been of long and very substantial concern to our members and the association, and we are very much heartened by the chairman's sensitivity to these problems and the action that he has taken in proposing this legislation.

We would acknowledge the need to reestablish a greater spirit of competition within the banking community. However, our primary concern is the matter of the erosion of the line of demarcation between banking and commerce, particularly as it would relate to life and health insurance. We have expressed concern about this issue on previous occasions and certainly recent publicized events regarding problems of banks and commerce have served to heighten our concern and to confirm many of the fears that we have previously expressed.

We are also troubled by public statements by officials charged with responsibility of regulating the various segments of the banking industry wherein they seem to advocate the further movement of banks into commerce to increase profitability of banks and if, indeed, this be the attitude of the regulators, then we see little hope of curing the problem from that sector.

So if a solution is to be reached, we would certainly agree that Congress will have to act.

With respect to Senate bill 2721, we strongly support the provisions restricting nonbanking activities and the statement which we have filed with the committee makes reference to the presence of unfair competition in the marketplace, resulting in tie-in sales, various forms of coercion, both direct and voluntary, and we would offer these as justification for imposing such restrictions.

However, we would also like to urge that the bill be strengthened by additions or amendments to state those specific activities that should either be permitted or prohibited activities by banks or bank holding companies, particularly with respect to insurance which seems to be unusually vulnerable to this kind of phenomena. We believe that such action would avoid the questionable interpretations that have come from the regulatory authorities in the past and we acknowledge the difficulty, of course, in these interpretations with construing terms such as "closely related" or "closely and

directly related," or words like "convenience," which can be readily stretched to extremes to accomplish a particular objective.

We also realize that various terms mean different things to different people. For example, in our own business, the term "credit life insurance" means something different to people within the insurance industry than it does to those persons without. When life insurance people refer to credit life insurance, they are talking about a specific product, whereas credit life insurance to people outside of our industry very often has a much broader connotation and might refer to insurance issued in connection with any kind of a credit transaction. To life insurance people credit life insurance is a specific product and is a group life insurance product which is ordinarily issued to the debtors of a creditor on a nonmedical without evidence of insurability basis. It is normally defined and limited by State statute and typically would have a limitation of about \$10,000. It was specifically designed to cover such things as small loans, so-called big ticket items like automobiles, boats, and major appliances, that people might buy and finance. This is the particular product that we refer to as credit life insurance and yet, many times it is spoken of by others in a much broader sense in terms of any kind of credit transaction far beyond those limitations.

We feel it is important to make this point because the insurance people sometimes concede that it is arguable that credit life insurance might be a related banking activity. But when they do so, they are referring to a specific product and not the whole general area of the extension of credit. This is a particular problem because credit life insurance has been one of those areas that has been particularly sticky with respect to the performance of lenders in the marketplace and we would certainly share the concern the chairman of this committee has expressed on occasion with regards to the abuses and the marketing of credit life insurance by lenders.

In our perspective this issue has two parts: What has happened to date and what could happen in the future? With regards to what has happened, it is a matter of general knowledge that the public has been substantially overcharged for this product and this has been brought about largely by the phenomena of reverse competition wherein many times the bank or the lender might be attracted to the company offering the highest statutory rate coupled with the largest profit margin for the lending institution as opposed to the product that might be more reasonable for the consumer. Many States have attacked this problem by State insurance laws. These States have been very frustrated because they have seen their law circumvented by the use of captive reinsurance companies to maximize profits, many of which have been located out of State. The proliferation of limited capital companies in my own home State of Arizona, which were formed expressly for this purpose, certainly attest to this continued practice. We also believe that it is significant that the only life insurance product of all of the life insurance products currently being marketed that the States have seen fit to regulate the rate on has been credit life insurance and this has occurred because of these abuses.

With regard to what could happen, we have great fear that these abuses can be extended into other areas of so-called credit transactions and this track record would indicate that this could occur because there are greater opportunities beyond this limited definition of credit life insurance in terms of larger sales. We have no reason to believe that it cannot happen.

We believe that there's an additional need for precise legislation with regard to insurance prohibitions stemming from the need to assist the States in their legislation. Some States have been concerned about this problem and have acted to curb the expansion of banks into insurance and while the laws have not been uniform, they have in one way or another usually approached the problem with their licensing powers. Other States have been interested in the problem but have been stymied because there are States where the banking community is controlled by a few very powerful banking systems and passing such legislation is very difficult. Other States have been uncertain as to exactly what to do as to exactly what activities should be permitted and which should be prohibited.

We believe that it would be helpful to the States in providing guidance if they were to know what areas Congress felt would be appropriate or inappropriate areas to be licensed. We are particularly pleased with sections 601 and 701 of S. 2721, which would establish better procedural requirements for the actions of regulatory authorities. This has been a past irritant because meaningful appeal has been virtually impossible. We also applaud the ongoing supervision provision of the bill which we believe will assure the continuing public benefit in overseeing bank holding company activities.

In closing, Mr. Chairman, I would simply reiterate our plea that specific provisions be provided in the law with regard to specific activities that either are prohibited or permitted and, again, we thank you for this opportunity to appear before you today in support of this bill, which we feel is a great step forward in solving what we regard as a very serious problem. We wish the committee success in developing this legislation.

The CHAIRMAN. Thank you very much, Mr. Bobo.

[Complete statement of Mr. Bobo follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

By Jack E. Bobo, CLU

Mr. Chairman and Members of the Committee, I am Jack E. Bobo, Secretary of the National Association of Life Underwriters (NALU) and Chairman of its Federal Law and Legislation Committee. NALU is a federation of over 1,000 state and local associations representing approximately 135,000 life and health insurance agents, general agents and managers. I would like to take this opportunity to thank the Committee for permitting me to testify today on behalf of NALU in support of S. 2721.

NALU has long been vitally interested in legislation which seeks to protect the consumer from the results of undue concentration of resources and economic power in any segment of the economy, from decreased or unfair competition, conflicts of interest, unlawful tying arrangements and coercion. We believe that you, Mr. Chairman, have demonstrated your concern about these dangers to the consumer and the economy by introducing this legislation,

designed to reestablish competition within the banking industry while at the same time insuring that a healthy line of demarcation is maintained between banking and commerce.

Although NALU is concerned with the increasing concentration of power within the banking industry itself, the members of our association have been primarily concerned with and affected by the expanding diversification of bank holding companies into areas which have been traditionally regarded as non-banking activities. In our viewpoint, this extension of the banking institutions of our nation into a variety of other business endeavors has resulted in unfair competition between banks and affected business as well as harm to the American consumer.

The events of recent times in the banking industry have demonstrated the economic consequences of banking institution involvement in non-banking activities. The collapse of major banking institutions and the serious drain on managerial and financial resources which have recently been the subject of numerous articles in newspapers around the country stemming from banking entry into other fields have, hopefully, put to rest the notion that the American public's deposits in major financial institutions can always be safely channeled into ventures which have no relationship to traditional banking activities.

NALU agrees with the competitive concerns expressed in a report of a survey conducted by the House Committee on Banking and Currency released in 1969 which listed three major adverse consequences resulting from the mixing of banking and non-banking activities within the same corporate structure. These adverse consequences were stated thus:

"(1) There is inevitably a strong temptation to have the banking subsidiary of a holding company extend large amounts of credit, perhaps unwisely, to other holding company subsidiaries, thus creating unsound financial conditions for the bank to the detriment of the bank's depositors, stockholders and the public at large. This is the kind of activity in which some of the larger banks in the country were engaged in the 1920's.

(2) "Since banks are the principal suppliers of substantial credit to almost every industrial, commercial and other kind of business in the United States, banks should not be in a position to discriminate unfairly against these users of bank credit by establishing competing subsidiaries and then denying credit to the competitors of the bank's non-banking subsidiaries. This is a particularly serious problem in the many cities and towns all over the United States where there are only one or two major banking institutions to which business can turn for substantial amounts of credit.

(3) "Because many large and small businesses, as well as individuals, depend on bank credit for their economic existence, bank subsidiaries of one-bank holding companies are in a position to insist or 'strongly suggest' that if the borrower wants continued access to bank credit, it should also use the services of the holding company's other subsidiaries. These services might include insurance, equipment leasing, property management, accounting, computing, investment and travel services or any other business the holding company might decide to undertake. This would create unfair competition for non-bank related competitors of these subsidiaries and could in the long run substantially reduce or eliminate competition in many businesses to the detriment of the public interest." [Staff of House Committee on Banking and Currency, 91st Cong., 1st Sess., Report on the growth of unregistered bank holding companies. (Comm. Print 1969)]

Regarding the possibility of coercion noted in (3) above, I would only add that such practices have been well documented in past hearings before this Committee with respect to insurance activities carried on by banking institutions. There is also the distinct possibility of what has become known as "voluntary tying" which may arise when banking institutions are permitted to enter fields not directly related to banking. A good description of the dangers of voluntary tie-ins was provided this Committee by Assistant Attorney General Richard McLaren during the 1970 Hearings on the Bank Holding Company Act amendments. In his testimony, Mr. McLaren referred to a situation,

"(W)here a potential borrower may independently decide that, just because he might possibly be under watch, it is in his best interest to patronize bank-affiliated enterprises in the hope of improving his chances of obtaining credit from the bank on favorable terms, or indeed at all.

"This can be illustrated by an example. A potential loan applicant might voluntarily place his casualty insurance business with a bank-affiliated insurer in hopes of improving his chances for a mortgage loan on the insured property on favorable terms. This would have the same effect as a coercive tie-in. Competition in the tied product, insurance, would be lessened to the extent that customers no longer purchased it entirely on its own economic merit. One such merger might well trigger others and, as a pattern of such bank-insurance affiliations developed, market foreclosure in the tied field would become more and more serious.

"Such voluntary tying or tying effect, as we called it in a recent case, is the product of market structure-not misconduct.

"This structural problem is intensified because present antitrust remedies appear inadequate to deal directly with it. There simply is no illegal practice or conduct for a court to enjoin. Hence, we must concentrate on avoiding a structure which gives rise to such effects." [Hearings on Bank Holding Company Act amendments before the Senate Committee on Banking and Currency, 91st Cong., 1st Sess. (1969)]

Section 301 of S. 2721 provides for important restrictions on the permissible non-banking activities which may be carried on by bank holding companies and the proposed amendments to Section 4(c) (8) of the 1956 Bank Holding Company Act as amended are a commendable and necessary addition to the current law.

While NALU fully supports these provisions, we also feel it desirable that the bill be strengthened to state those activities which are specifically prohibited to bank holding companies. We feel such a statement is important due to the fact that there are certain non-banking activities which have been deemed permissible for bank holding companies in the past despite the apparent Congressional intent behind the 1970 amendments to the Bank Holding Company Act of 1956.

For some time, NALU has become increasingly alarmed by the growing encroachment of banking institutions into the insurance agency business generally, and more particularly the sale of life and health insurance by bank affiliated agencies. While sales of life insurance and health insurance have not been deemed permissible activities for bank holding companies per se, such products have been permitted to be marketed by general insurance agencies affiliated with bank holding companies because of a Federal Reserve Board Regulation promulgated subsequent to the passage of the 1970 Bank Holding Company Act amendments. This Regulation permits a bank holding company or its non-banking subsidiary to market *any* insurance in communities of 5,000 or less. The Regulation also permits any insurance to be sold when such insurance is "otherwise sold as a matter of convenience to the purchaser" so long as the premium income from such sales does not constitute a significant portion of the aggregate insurance premium income of the holding company from insurance sold by the holding company or its non-banking subsidiaries. Bank holding company non-banking subsidiaries have also been permitted to market certain mortgage redemption insurance policies in the form of insurance on the life of the mortgagor to the extent of the outstanding balance of the credit extension, provided that the mortgagee is a beneficiary under such types of insurance policies. Thus, banking institutions have made inroads into insurance agency activities which are not "closely related" to banking in many instances. Such activities have been permitted by the regulatory agency through what would appear to be an excess of its authority.

There are several additional reasons why NALU feels that certain insurance agency activities, including the marketing of life and health insurance, ought to be specifically prohibited to bank holding companies and I would like to take this opportunity to briefly mention two of them.

First of all, I would like to note that while it is apparent that the sale of life and health insurance is not "closely related" under the current law or "closely and directly related" under the proposed S. 2721 standard, such is not the case, unfortunately, with sales of certain credit life and health insurance products. For instance, it is arguable that the sale of credit life and health insurance, when issued in connection with a specific loan or other credit transaction may be "closely related" to banking under the current law and an argument would inevitably be mounted that this sale of credit life and health insurance would be "directly related" under the language of S. 2721.

Therefore, with respect to credit life and health insurance agency activities, where confusion may arise on the issue of precisely what non-banking insurance agency activities are permissible, it would seem appropriate to designate those insurance agency activities which are not "closely and directly related" or, conversely, provide a listing of the only insurance agency activities, if any, which would be permissible under S. 2721. Such action would be helpful in providing clarification to the regulatory agency regarding Congressional intent on arguably directly related credit insurance activities. Parenthetically, I would note that even though credit life and health insurance may be considered directly related to banking, NALU is opposed to the undertaking by banking institutions of any type of insurance agency activity, including the sale of credit life and health insurance. We applaud the Congressional finding in this bill that "bank holding companies have extended their services into product markets beyond those directly related to banking . . . (c) in offering insurance agency and underwriting services". Bearing importantly on NALU's feeling that prohibited insurance agency activities should be specifically listed in the bill is the deplorable track record of banking institutions in the field of marketing credit life and health insurance.

Here again, Mr. Chairman, you have been at the forefront of the fight to alert the American public about the abuses which have occurred in the credit life insurance industry involving banks and other lending institutions, as well as certain credit life insurance companies. As you noted in a Press Release from your office dated November 12, 1974,

"The sale of credit life, health and accident insurance is rapidly becoming a national scandal. The insurance is ostensibly written for the benefit of a consumer who borrows money or buys on the installment plan. In reality the insurance primarily benefits the creditor by paying off the loan if the consumer dies or becomes disabled. Nonetheless, the consumer is required to pay the entire premium which is often double or triple what it should be. To add insult to injury, the creditor gets to select the insurance company.

"Given these methods of doing business, most creditors select the insurance company which offers the largest kickback. Naturally, the consumer winds up paying for these kickbacks in the form of higher insurance premiums. These kickbacks inflate the cost of the insurance and permit creditors to earn a higher rate of interest."

NALU respectfully submits that if banking institutions have shown a proclivity for making money at the expense of the American consumer through their marketing methods of credit life and health insurance, and the record of that is well documented, then banking institutions ought to be affirmatively prohibited from becoming involved in insurance agency activities where they have little or no experience and expertise and certainly no justifiable direct banking interest.

Secondly, NALU feels it advantageous to specifically list those insurance agency activities which are not permissible for bank holding companies in order to help avoid any conflicts which might arise due to contemplated state legislation. Currently, as many of you are no doubt aware, the business of insurance is almost exclusively state regulated. Several state legislatures, concerned by banking intrusion into the insurance agency business, have recently enacted restrictive state insurance licensing laws prohibiting the state insurance regulatory authorities from issuing licenses to sell most insurance products (except for certain credit insurance) to agents and agencies who are affiliated with lending institutions.

Inasmuch as many other similar state bills have been introduced recently, a list of those insurance agency activities prohibited to bank holding companies and their subsidiaries would probably provide helpful federal direction to those state legislatures who wish to shape their bills to coincide with federal laws.

NALU also supports the provisions of Section 401 of S. 2721 entitled "Uniform Application of Standards Governing Entry into Bank Related Fields". We feel it very important that there be a consistency in decisions emanating from the two primary Federal regulators of bank holding company subsidiaries—the Federal Reserve Board (charged with the responsibility of regulating bank holding companies and their non-bank subsidiaries) and the Comptroller

of the Currency (charged with the responsibility for regulating national bank subsidiaries of bank holding companies) as far as the appropriate outer limits for expansion by bank holding companies into directly related areas is concerned.

Other provisions of the bill which appear particularly beneficial in protecting the public interest appear in Sections 601 and 701. Section 601 provides that Federal Reserve Board determinations of permissible 4(c) (8) activities (under the Bank Holding Company Act as amended) will be made on the record and, additionally, this section proposes helpful discovery rules and insures that relevant information pertaining to Board proceedings under 4(c) (8) will be available to interested parties to the proceeding. The general application of the Administrative Procedure Act to Federal Reserve Board rule-making proceedings is another desirable feature of this section of the bill.

The necessity for these changes was, in part, underscored by a staff report of the Subcommittee on Domestic Finance of the House Banking Committee issued in the latter part of 1973. This report noted the failure of the Federal Reserve Board to provide a useful record on which it based its decisions in several important cases involving interpretation of the Bank Holding Company Act as amended. This report stated the consequences of such failure as being that,

"(T)he due process of law is thwarted because those who seek to appeal decisions of the Board are unable to present the details of the Board's findings or its reasoning for purposes of rebuttal". (Staff Report of the Subcommittee on Domestic Finance of the Committee on Banking and Currency of the House of Representatives on Financial Institutions: Reform and the Public Interest, 93d Cong., 1st Sess., August 1973.)

Section 701 of the bill, providing for ongoing supervision of bank holding company 4(c) (8) activities by the Board, would seem particularly necessary due to the fact that the net public benefits to the public offered by bank holding companies are all too frequently short lived.

Invariably, as one compares this bill to the existing law, every provision on a section-by-section basis imposes public interest requirements on Federal Reserve Board proceedings conducted to determine what activities should be permissible for bank holding companies and their subsidiaries.

NALU feels strongly that this is a bill designed to protect the American consumer of banking services as well as the small businesses of America from the excesses perpetrated upon them by increasingly more powerful banking institutions and their expansionary and harmful entry into non-banking areas.

We urge that every member of the Committee give this bill top priority, and once more respectfully request the consideration of additional language further clarifying those insurance agency activities which would be prohibited under this proposed legislation.

In closing, I would like to present to you an excerpt from a recent decision of an Administrative Law Judge assigned to a Federal Reserve Board administrative proceeding in which insurance agents were challenging bank holding company entry into a wide variety of insurance agency activities. While this finding is of particular relevance to the membership of NALU, it would be equally applicable to many other small businesses engaged in non-banking activities.

The Judge reached the following conclusion as part of his decision,

"The proposition reduced to its simplest terms comes down to this: if a bank large in its community, using predominantly depositors' funds as capital, is authorized to compete against mostly small insurance enterprises by soliciting its debtor clientele, it is possible, even probable that the Mom and Pop agency will be driven into merger or out of the business entirely; and to this extent, the American dream of a land of opportunity where every man and woman, with some skill and good luck, can become a proprietor or a partner, rather than merely a clerical employee or an insignificant stockholder, will fade further . . ." (Recommended decision of Paul N. Pfeiffer, Administrative Law Judge, FRB Docket N. 1A-10(1974)).

Mr. Chairman and Members of the Committee, I thank you once again for permitting me to express NALU's support of this fine legislation.

The CHAIRMAN. I have received a written statement from Mr. Albert E. Abrahams, director, government affairs department, National Association of Realtors concerning S. 2721. I ask unanimous consent that the statement be printed at this point in the hearings. [The statement follows:]

STATEMENT OF ALBERT E. ABRAHAMS, DIRECTOR, GOVERNMENT AFFAIRS DEPARTMENT ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS

The National Association of Realtors is comprised of more than 1,630 local boards of Realtors located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is approximately 500,000 persons actively engaged in sales, brokerage, management, counseling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums. The Association has the largest membership of any association in the U.S. concerned with all facets of the real estate industry. Principal officers are: Philip C. Smaby, President, Minneapolis, Minnesota; Harry G. Elmstrom, First Vice President, Ballston Spa, New York; and H. Jackson Pontius, Executive Vice President. Headquarters of the Association are at 155 East Superior Street, Chicago, Illinois. The Washington Office is located at 925-15th Street, N.W., Washington, D.C. 20005. Telephone: 202 628-5300.

"COMPETITION IN BANKING ACT OF 1975" (S. 2721)

The membership of the National Association of Realtors has long been concerned about the growth of bank holding companies, and their involvement in ever increasing kinds of activities only remotely related to banking. This Association wishes to commend Senator Proxmire for his sponsorship of S. 2721 which, in our opinion, will aid in a more balanced allocation of future bank holding company activities.

The 1970 Amendments to the Bank Holding Company Act extended its coverage to one bank holding companies, and authorized the Federal Reserve Board to exempt from the general prohibition against engaging in non-banking activities such "activities . . . which the Board after due notice and opportunity for hearing has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto."

The 1970 Act also directed the Board to permit only banking-related activities which could reasonably be expected to produce benefits to the public—greater convenience, increased competition, or gains in efficiency—that might outweigh possible adverse effects such as undue concentration or unfair competition.

As a result, Realtors and other groups have become increasingly concerned that the continued expansion of bank holding company powers will make it impossible for the small, independent company in many aspects of the real estate business to compete with the holding company giants.

In the past year, this growing opposition, combined with the unstable condition of the economy, has made the Federal Reserve Board somewhat more restrained in its approval of new activities. This conservatism, however, has been clearly and explicitly directed at protecting the economic strength and solvency of the holding companies themselves, rather than in any acknowledgment that their activities should be curtailed because of adverse effects on the industries into which they were making inroads. It seems clear, therefore, that an economic recovery will bring a renewed surge of expansionary activity, unless Congressional action leads to statutory limitations.

Realtors believe that housing is one industry where competition is still a working reality. The industry is composed of lenders, attorneys, title companies, insurance companies, Realtors, and many others both small and large. We believe that this diversity and the scale of these market components creates true competition which serves the consumer by lowering costs, improving service, and offering a meaningful freedom of choice.

This system, however, is made up of small and diverse components and is thus uniquely vulnerable to absorption by an industry with large resources such as the bank holding company system. There is a growing fear that our general economy will eventually be controlled by a few giant banking institutions. This view is supported by the concentration of banking resources, which has already reached an alarming level. According to a Senate Banking Committee report, the last six years has seen the percentage of bank deposits controlled by bank holding companies increase from 38% to 71%. Concentration into fewer and fewer hands has increased, from 144 large banks in 1950 controlling 50% of all bank deposits, to only 81 banks in 1974 controlling 50% of all bank deposits.

The commercial banks of this country have resources unparalleled by any other sector of the economy and this vast economic force has been showing a clear and growing pattern of interest in housing activities such as mortgage guarantee insurance, real estate brokerage, appraisal, property management, savings and loan operation and others.

At present, holding companies are permitted to engage in activities of finance companies, mortgage companies, leasing of real and personal property, management consulting for banks, and advisory services for real estate investment trusts. Applications have been made for permission to engage in mortgage guarantee insurance and savings and loan associations. While acquisition of these activities by bank holding companies was disapproved by the Federal Reserve Board for technical reasons, the Board has stated that they deem these activities to be closely related to banking. It is clear, therefore, that this issue will be raised again.

We believe that such activities are not intended by Congress to be construed as "closely related" to banking when it enacted the Bank Holding Company Act Amendments in 1970. The legislative history of the 1970 Act reveals that Congress did not define the precise boundaries of "closely" related, and, as a result, a myriad of interpretations have arisen. This Association supports S. 2721 in its goal of narrowing permissive 4 (c) (8) activities from "closely related" to "directly related," and would impose more stringent "public interest" tests requiring that the activities be likely to benefit the public and increase competition.

In addition, the National Association of Realtors supports the extension of bank holding company regulation to national banks. The allegation has been advanced that the Comptroller of the Currency, who in a sense is in competition with the Federal Reserve Board for approving Section 4 (c) (8) applications, has been most permissive regarding the acquisition of non-banking subsidiaries by national banks. While the Fed has pursued a liberal policy in approving Section 4 (c) (8) activities, the Comptroller has permitted an even wider range of activities for national banks. We strongly urge that regulations covering bank holding companies be extended to cover national banks.

Protection of the traditional roles in financial transaction dictates that a clear and unmistakable line be drawn between the lender of money and the user of money.

Therefore, we strongly endorse a list of specifically prohibited activities similar to the one contained in the House passed version of the amendments to the Bank Holding Company Act of 1970.

While the Association supports amending the Bank Holding Company Act to change the emphasis of permitted bank holding company activities from "closely" to "directly" related to banking, it also strongly feels that the inclusion of a list of specifically prohibited activities to be in order. The Federal Reserve Board has consistently supported bank holding company activities into areas only peripherally related to banking, eroding the line between banking and commerce in the Nation. Therefore, this Association strongly suggests the inclusion of such a list of prohibited activities specifically directing the Board as to which activities are clearly not related to banking in view of the Congress.

In our opinion, the following activities, of which the first is now permitted and the others are now prohibited by the Federal Reserve Board, should be specifically prohibited by statute.

Leasing of real or personal property (A BHC may act as agent, broker, or advisor in leasing such property under existing law).

Real estate brokerage.

Management consulting (other than for banks).

Property management—except for properties owned or held by BHC's.

Land development.

Real estate syndication.

Operation of savings and loan associations.

Underwriting of real estate mortgage guaranty insurance.

Real estate appraisal.

These specifically prohibited activities would clearly indicate the sense of the Congress that expansion of bank holding companies into independent real estate fields constitutes a long range threat to competition.

This Association strongly supports the provision to make all Board proceedings under Section 4 (c) (8) subject to the Administrative Procedures Act, and on the record. The current practice of permitting the Board to decide on the level of formality during such hearings severely mitigates against parties opposing proposed Board actions, as opportunities for discovery, cross examination, and similar safeguards are not present. Critics of this proposal will argue against it on the grounds that it is time consuming and unnecessary. However, the very formality and preciseness of a hearing of record makes this provision necessary. Relationships between regulator and regulated will be much harder to conceal.

Surely, an industry as powerful and as important as banking requires the utmost safeguards in protecting the public interest. Full public hearings of record will go a long way in providing this protection.

In conclusion, while this Association recognizes and sincerely appreciates the financing support for housing and real estate that comes from commercial banks, and other bank holding company subsidiaries, we strongly feel that permissible bank holding company activities should be specifically confined to financial matters directly relating to banking. We also feel that non-banking activities by bank holding companies should not be permitted in a field such as real estate, a field characterized by an almost textbook description of competition by a large number of buyers and sellers.

STATEMENT OF EDWARD J. SCHMUCK, ON BEHALF OF CONNECTICUT MUTUAL LIFE INSURANCE CO., THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, MASSACHUSETTS MUTUAL LIFE INSURANCE CO., THE MUTUAL; LIFE INSURANCE CO. OF NEW YORK, NEW ENGLAND MUTUAL LIFE INSURANCE CO, THE NORTHWESTERN MUTUAL LIFE INSURANCE CO.

Mr. SCHMUCK. Good morning, Senator Proxmire. My name is Edward J. Schmuck. I'm a member of the law firm of Sutherland, Asbill & Brennan, and I appear here today on behalf of six clients of our firm which we have listed in our statement. Each of those companies I may say is a nationally known mutual life insurance company.

Mr. Chairman, I would ask that for the record the statement which we have submitted be included in its entirety with two modifications of typographical error.

The CHAIRMAN. We'll be happy to do that. We will have it printed in the record in full with the modifications you suggest.

Mr. SCHMUCK. These were simply change of one word and the elimination of another.

First, I think I ought to set the context within which we are appearing here today by invitation from this committee which we

appreciate, and to make clear that our appearance is in support of those portions of S. 2721 which are designed in the first instance to limit the nonbanking commercial activities of bank holding companies and their subsidiaries and affiliated corporations; and second, to strengthen the administrative procedures of the authorities charged by Congress with the regulation of such activities and the court review of the administrative actions of these regulators.

It was an interesting development that beginning in 1974 first one company and then successively the other five which we have listed, came to us with the request that we independently check on complaints that they were receiving in increasing numbers and strength from members of their field forces about what appeared to be a strongly anticompetitive development resulting from the increase in the marketing of life and disability insurance by bank holding companies and their related organizations.

The complaints generally fell into two categories: that by virtue of the exercise of economic clout, either explicitly or implicitly, banks were causing customers who required normal banking services either to drop or to curtail by putting on a paid-up nonpremium status existing insurance, or that they were forcing in such a manner the purchase of new insurance perhaps not otherwise needed in connection with a pending banking transaction.

We considered these to be quite serious complaints and we proceeded to exercise the authority given to us, an unrestricted authority, to make an independent investigation. We quickly verified what our clients had suggested strongly to us, that there is no basis, of course, for any blanket condemnation of the activities of bank holding companies, banks or any other affiliated corporation who are engaged in some limited way in the sale, marketing if you will, of insurance. A number of banks, as far as we can determine, still maintain the position of not sponsoring any insurance to meet any requirements that may be imposed in connection with banking transactions. A bank of that kind requires its customers to go to a normal source, a normal insurance source, to make the selection of both the agency and the company from which it will acquire the necessary insurance.

Another group of banks are adhering to the traditional role of providing through the kind of group contract Mr. Bobo mentioned, credit life or disability insurance directly related both in amount and in duration to a loan or other banking transactions.

We became convinced, however, that there is a growing number of banks and bank holding companies which have seized upon the 1970 amendments to the Bank Holding Company Act and the subsequent expansive Federal Reserve Board interpretations to market insurance under conditions which point strongly to unfair and improper use of the economic powers of the banks in conducting those controlled and affiliated insurance operations. We advised with our clients in respect of our findings and it is on the basis of the acceptance of those findings by our clients that we appear here because our clients are convinced that if this seeming trend continues it will become, as it now is to some extent, extremely inimical

to the orderly and competitive marketing of insurance by the normally well-trained professional agent.

The practices which we have referred to in our statement, in our judgment, also are destructive of the public's right to a free choice of an insurance agency and the right to secure the best insurance at the most competitive price to meet the individual's insurance needs. We see a need therefore for the kind of provisions that are included in S. 2721 to restore to a substantial extent the traditional wall separating banking from commerce. We think that the provisions of S. 2721 as presently designed substantially accomplish the needed legislation.

We have several minor suggestions for perhaps strengthening some of these provisions and two of those are reflected in our statement, one dealing with the possible limitation of the grandfathering clause that we think might be carefully considered by this committee.

In our investigation we had the unusual experience early on of getting perhaps the clearest, most direct, most honest and succinct statement in writing of the type of anticompetitive activity that we could possibly have dreamed of. It was a letter written by the executive vice president of a bank to an insurance man. We have quoted the letter with names deleted in its entirety in our statement. I think this is of such importance however that I will impose upon the committee to read the entire text.

The CHAIRMAN. What page is that on?

Mr. SCHMUCK. Pages 5 and 6, Senator. I will read it with "Mr. X" instead of "Name deleted."

I regret very much the incident concerning "Mr. X". I based my decision regarding this matter on what I thought to be the best interest of "Mr. X" and the bank. As I indicated to "Mr. X", our bank could not accept the loan unless we were allowed to write the credit life insurance. As I discussed by phone, the primary reason for this request to write the insurance, was because this action increased the return of income on the loan by a good margin. Had our bank been denied this additional income, we could not have approved the loan. Because of the extremely tight credit situation, I feel "Mr. X" would not have obtained the loan elsewhere. Therefore, I believed our bank to be doing "Mr. X" a service by granting this type of loan under these circumstances, with credit as tight as it is at present.

I can still appreciate and understand your reasoning and regret that "Mr. X" saw fit to cancel his policy with your company. I am hopeful this situation will not occur again in the future.

As I have indicated in the footnote, we are prepared to make a photocopy of that letter available to this committee. If confession is good for the soul, I think this man should sleep easy at night.

Generally, the activities are carried on much more subtly in using what we think is the economic pressure improperly to encourage the purchase of insurance through a bank affiliated insurance agency. Often it comes in the form of a suggestion, a suggestion that the purchase of insurance will be a necessary part of the loan package and that perhaps it should be purchased from the bank's affiliated organization. That suggestion, we think we have established quite definitely, is treated by its recipient as a requirement and we have cited some statistics in here that we think reinforce that conclusion.

I was tempted seriously to stop with the reading of the letter and say it speaks for itself and it demonstrates the entire problem that has arisen as a result of expanding the activities of the banks in the insurance area. However, at pages 8 and 9, we did think that it was desirable to at least summarize some of the patterns which were verified during the process of our independent investigation.

In Georgia, for example, a major bank had an established policy that required its loan officers to introduce applicants for loans to the bank's affiliated insurance agents while the loan application was being processed. I'm not certain of this at this moment, but we have had an indication that this bank has since terminated this particular requirement or at least the imposition of the policy upon its loan officers.

In Oklahoma, we determined that several banks, publicly and in writing, offered lower interest rates on loans if insurance were purchased through the banks.

We have cited two instances that we uncovered in North Carolina. In one of them, a bank policy was apparently imposed to permit the affiliated insurance agencies access to the bank records as a basis for approaching individuals for the purchase of new insurance.

In Pennsylvania, we determined that there is at least one case in which a given bank advised a customer that he must secure his life insurance through a bank affiliate in order to secure a desired line of credit.

In Minnesota, two businessmen who were attempting to renegotiate existing loans in real estate transactions were requested to purchase, each, \$1 million of additional life insurance through the bank's affiliated agency as a condition of refinancing along the lines that these individuals had requested.

Clearly, it seems to us to require no argument that suggestions of that kind, coupled particularly with pending loan applications but often with the continuation of a line of credit, are going to be taken by the individual, whether a businessman or just a consumer-applicant for an automobile or a comparable small loan, as a necessary requirement, and we are satisfied that this is going on and we are equally satisfied that it is growing.

In part, we feel that this has resulted from a policy on the part of the Federal Reserve Board to encourage the diversification, if you will, of the banks and the bank holding companies into activities that are not directly related to the performance of their normal banking functions. The changes in the regulations and the interpretations dealing specifically with the area of insurance have considerably expanded the powers that the banks and bank holding companies had prior to the 1970 amendments.

The enforcement or, if you will, the administration of the new regulations and the interpretations we have illustrated in our statement by a report of examination of the record of 488 applications made over a 2-year period by bank holding companies or affiliates to enter into the insurance agency business. Of those 488 applications, 437 were approved. Only 3 were denied. The remainder were either withdrawn or were pending at the time the study was made. There were comparable statistics available for other periods of time.

The grossest extension we think of the power of the banks and bank holding company affiliates to compete unfairly with the insurance agent, the small businessman who is in the insurance business, is the so-called convenience provision of the regulations under the 1970 amendments. This permits any bank authorized to embark upon the marketing of insurance to sell insurance for the convenience of its customers without regard to any bank-related activity that might be going on at that time. And by interpretation, the Board has promulgated that if the premiums on such convenience totally unrelated—that is in a banking sense—totally unrelated sales of insurance do not exceed 5 percent of the total premium volume of the insurance affiliate of the bank, that will normally be acceptable. I have some difficulty with carrying any portion of either the regulation or the interpretation as to these convenience sales through into the closely related test that Congress imposed in the statute.

Finally, we are convinced that it is only by virtue of legislation such as has been proposed in S. 2721 that the true competitive market situation is going to be restored to a normal balance and that unless action is taken along the lines proposed in S. 2721 there will be an increasing use of what I term economic clout which will inevitably increase the anticompetitive aspects of the incursion of banks into the insurance marketing area and will be increasingly destructive of the right of free choice of bank customers to acquire any necessary insurance.

Thank you, Mr. Chairman.

[Prepared statement of Mr. Schmuck follows:]

STATEMENT OF EDWARD J. SCHMUCK

My name is Edward J. Schmuck. I am a member of the law firm of Sutherland, Asbill & Brennan, with offices in Washington, D. C. and Atlanta, Georgia. I appreciate the opportunity to appear before this Committee to testify in support of those provisions of S. 2721 which are designed, first, to limit the nonbanking commercial activities of bank holding companies and their subsidiaries and affiliated corporations, and second, to strengthen the administrative procedures of the authorities charged by Congress with the regulation of such activities and the court review of the administrative actions of those regulators.

I make this appearance on behalf jointly of the following clients of our firm:

Connecticut Mutual Life Insurance Company, Hartford, Conn.

The Equitable Life Assurance Society of the United States, New York, New York.

Massachusetts Mutual Life Insurance Company, Springfield, Mass.

The Mutual Life Insurance Company of New York, New York, N.Y.

New England Mutual Life Insurance Company, Boston, Mass.

Northwestern Mutual Life Insurance Company, Milwaukee, Wisc.

By way of brief background, we were employed first in 1974 by one company and then successively by the five other companies. Each had become concerned by complaints from responsible members of their respective agency forces that existing life and accident and health insurance of established policyholders was being replaced or curtailed by the explicit or implicit demand of bank holding companies and their banks that such insurance be purchased through bank affiliated insurance agencies. Opportunities to compete for the sale of new insurance were also being stifled. The complaining agents protested the elimination of normal competitive opportunities by the exercise of economic pressures by bank officers and employees, sometimes exerted on mutual customers of the banks and the insurance agents in connection with a

new loan or other banking transaction and sometimes unrelated to any new banking transaction.

We were authorized to investigate independently the factual basis for complaints of this nature and to advise our clients whether we perceived a current or potentially serious threat to the traditional highly competitive marketing operations in the insurance industry through the entry of bank holding companies and their affiliates into the business of selling insurance. We knew that to businessmen and consumers generally in need of normal banking services, even the suggestion of placing insurance through a bank affiliate can be the full equivalent of economic coercion of the worst kind.

Our investigation verified, as our clients had strongly suspected, that a blanket condemnation of bank holding companies and their banks and other subsidiaries clearly would be unwarranted. Some bankers continue the policy of not offering bank sponsored insurance, leaving to the individual bank customer the selection of his own agent and insurance company to provide any insurance required in support of a banking transaction. Other banks adhere to the traditional role of providing (normally through a group insurance contract or contracts) credit insurance coverage in amounts and for durations directly related to the loan or other banking transaction. We became satisfied, however, that a growing number of banks and bank holding companies are seizing upon the 1970 amendments to the Bank Holding Company Act and expansive Federal Reserve Board interpretations to market insurance under circumstances which point strongly to unfair and improper use of the economic power of the banks in conducting those controlled and affiliated insurance operations.

Our clients are in accord that such activities, particularly if they continue to increase unchecked, are inimical to the orderly, normally competitive marketing of insurance by highly trained professional agents. They are destructive of the public's right to free choice of an insurance agency and the right to secure the best insurance at the most competitive price to meet the individual's insurance needs. In our opinion, these practices can only be effectively dealt with by restoring the traditional wall separating banking from commerce.

S. 2721 would help to return banks to the business of banking. Under its provisions, bank holding companies would be properly limited to activities that are both directly related and necessary to banking. Specific additional criteria for a separate "public benefits" test would have to be satisfied before such activities could be engaged in thereby insuring that the proposed commercial activity was at least needed in the community.¹

In order to curtail "rubber stamp" approval of nonbanking activities by the Federal Reserve Board, S. 2721 would also require that rule-making and adjudicatory proceedings under the Bank Holding Company Act be conducted pursuant to the Administrative Procedure Act. Moreover, it would significantly increase the present limited scope of judicial review of Board actions. These provisions would act as a safeguard to assure that Congressional intention under the Act is carried out.

We have been requested, therefore, to reflect the support of our client companies for the nonbank affiliated insurance agents who seek to have the insurance activities of the banks and their holding companies at least rolled back, as S. 2721 proposes, to the minimum which may be deemed directly related and necessary to the business of banking.

It is against that background that I appear here today.

UNFAIR AND COERCIVE BANK ACTIVITIES

The power of a bank to grant credit, which is the life blood of many small businessmen and consumers, allows a banking institution to "offer" insurance to customers on coercive terms they dare not refuse to accept. Although most bankers are discreet in exercising such coercive power, some have openly admitted that they require loan applicants to purchase insurance from the bank's

¹ See the Appendix hereto detailing the legislative background of Section 4(c)(8) of the Bank Holding Company Act, which would be amended by S. 2721, and the Board's highly questionable interpretation of Congressional intent as it related to Section 4(c)(8).

insurance department or affiliated agency as a condition for securing a loan or better loan terms. As a Vice President of a Virginia bank wrote in late 1974:

"Dear [Name Deleted]:

"I regret very much the incident concerning [Name Deleted]. I based my decision regarding this matter on what I thought to be the best interest of [Name Deleted] and the bank. As I indicated to [Name Deleted], our bank could not accept the loan unless we were allowed to write the credit life insurance. As I discussed by phone, the primary reason for this request to write the insurance, was because this action increased the return of income on the loan by a good margin. Had our bank been denied this additional income, we could not have approved the loan. Because of the extremely tight credit situation, I feel [Name Deleted] would not have obtained the loan elsewhere. Therefore, I believed our bank to be doing [Name Deleted] a service by granting this type of loan under these circumstances, with credit as tight as it is at present.

I can still appreciate and understand your reasoning and regret that [Name Deleted] saw fit to cancel his policy with your company. I am hopeful this situation will not occur again in the future."²

More subtle bank pressure can be equally invidious. A bank loan officer may merely "suggest" or "recommend" that the loan applicant consider purchasing life or accident and health insurance through the bank's agency or affiliate. This, it is "suggested," would be the most "convenient" way to reinforce a loan application to assure its early and favorable consideration. Quite naturally, the loan applicant considers this "suggestion" as a requirement which must be met to obtain the loan. Thus, customers perceive the implicit threat of the deprivation of a needed banking service and submit, usually without public protest, to the "recommended" purchase of insurance.

Such coercion, direct or subtle, obviously eliminates meaningful competition by nonbank affiliated insurance agents. These agents already engage in one of the most competitive of all businesses. They are usually small independent businessmen operating their agencies in communities throughout the country. Neither such agents, nor their insurance clients, can successfully oppose the overwhelming economic power of banking institutions which themselves seek to sell insurance.

Many Senate and House members recognized during the hearings and floor debates leading to the 1970 Amendments to the **Bank Holding Company Act** the undesirable effects that could easily occur if bank holding companies were allowed to engage in nonbank activities not directly related to banking. An excellent summary of these problems was made by Senator Brooke of Massachusetts in a Senate floor speech on May 11, 1970:

"The combination of banking and nonbanking operations under a single management raises serious public policy implications. It is argued that if banks become too closely involved in other business activities, either directly or through holding companies, the managers of the bank might be induced to make unsound loans in order to further their other business interests. . . .

"It has also been argued that commercial banks inevitably tend to lessen competition when they compete in areas outside the business of banking. Thus, banks can discriminate against their nonbanking business rivals by denying them favorable access to bank credit and by granting this to their nonbanking affiliates. This is a particularly serious problem in many cities and towns where there are only one or two major banking institutions to which businesses can turn for substantial amounts of credit.

"Banks also discriminate against their nonbanking rivals by unfairly luring customers away. This is accomplished by offering customers of their affiliates favorable access to bank credit or by suggesting to bank customers that if they want continued access to bank credit, they should also use the services of the holding company's other subsidiaries. Indeed, there is evidence that such tie-in arrangements are deeply rooted in traditional banking practices.

"Banks can very effectively use their economic leverage to decrease competition in highly competitive, nonbanking industries characterized by a relatively large number of smaller firms * * *."

² A photocopy of this letter is available for the Committee's reference.

The prophetic statements of Senator Brooke and others have regrettably come true. The record now shows that banking interests in many parts of this country have used unfair, and perhaps illegal, pressure to enhance the competitive position of their nonbanking divisions or affiliated companies. This pattern has been particularly prevalent when insurance is involved.

With regard to the sale of insurance, a few examples will demonstrate the typical pattern of abuse that has emerged around the nation:

In Georgia, a major bank had an established policy requiring its loan officers to "introduce" loan applicants to the bank's affiliated insurance agents while the loan application was being processed.

In Oklahoma, during the period of tight money last year, several banks offered lower interest rates on loans if insurance was purchased through the banks.

In North Carolina, agents of a major bank's affiliated insurance agency frequently visited the bank's branch managers and advised them that management had suggested that the branch managers could assist them in locating insurance clients. Obliging, the managers referred the agents to bank customers.

Also in North Carolina, a bank affiliated agency contacted a businessman who had applied to the bank for a large line of credit. The agency strongly "recommended" that the businessman purchase a sizeable policy of convertible term life insurance to cover this desired line of credit.

In Pennsylvania, a similar case arose wherein a bank advised a customer that he must secure additional life insurance through a bank affiliate to secure his line of credit.

In Minnesota, two businessmen seeking refinancing of a large real estate project were each "requested" to purchase \$1 million life insurance policies through the bank if the refinancing were to be approved.

In most cases, of course, bank customers who have been subjected to bank pressures dare not publicly complain because they are justifiably afraid of jeopardizing their opportunities for securing credit in the future or endangering their existing loan situation. Nonetheless, the evidence demonstrates that cases such as those cited above are not isolated problems, but that, to the contrary, bank holding companies increasingly are making widespread use of such unfair and coercive practices to sell insurance.

Thus, a survey taken in late 1973 by the Carolinas' Association of Mutual Insurance Agents found that 84 percent of the agency members responding stated that their customers who had switched to a bank affiliated agency either felt obligated to buy insurance from the bank or felt that the purchase of such insurance from the bank agency would have a favorable effect on other noninsurance transactions with the bank. Similar abusive practices in other parts of the country have already prompted a number of states to enact specific legislation restricting banks activities in the insurance business.³

FAILURE OF FEDERAL BANKING REGULATION

In spite of the clear need for federal supervision to contain these practices, the Federal Reserve Board has failed effectively to deal with the problem and has in fact pursued a policy of encouraging bank expansion into non-banking activities. In the insurance area in particular, Board actions on bank holding companies' applications may be characterized by one word—approval. In the past two years alone, of the 488 applications which have been made to enter the insurance agency business, 437 have been approved, while only 3 have been denied.⁴

Despite the present requirement of Section 4(c)(8) of the Bank Holding Company Act that nonbanking activities must be "closely related" to banking, Regulation Y, promulgated by the Board in 1971, permits bank holding companies to sell *any* kind of insurance as a "convenience" to the purchaser, pro-

³ As of last summer the following states had passed legislation restricting bank holding companies engaging in the sale of insurance: Connecticut, Florida, Georgia, Maine, Mississippi, Nevada, New Jersey, New York, Pennsylvania, and Vermont.

⁴ The other applications have either been withdrawn or have not yet been subject to final Board action.

vided only that the amount of such "convenience" insurance does not exceed a "significant portion" of that company's insurance activities.⁵

While the Board has been quite willing to allow bank holding companies to engage in insurance activities that clearly are not closely related to banking, its recent decision forbidding bank holding companies to engage in another nonbanking activity, the travel agency business, shows that the Board lacks consistency in applying its own standards.⁶ In its decision the Board emphasized that travel agency business is not a traditional activity for banks, noting that fewer than 150 banks now provide travel agency services.

Yet if the Board's travel agency case standards had been applied to bank holding companies' applications to operate insurance agencies, it would have been impossible to justify the Board's approval of the sale of noncredit insurance. Traditionally, banks have not acted as agents in the sale of noncredit insurance. Thus, between 1956 and 1971, the Board received fewer than 25 applications by registered bank holding companies to engage in insurance activities and virtually all of those applications involved only credit-related insurance or agencies located only in rural areas. Since the operation of an insurance agency, like the operation of a travel agency, cannot be considered to be integrally or functionally related to banking, it is indeed peculiar that the Board correctly disregards the "convenience" factor in determining whether a travel service is closely related to banking, but nonetheless unjustifiably equates convenience with "closely related" in the insurance area.

LEGISLATIVE RELIEF NECESSARY

While the Board, facing severe political pressures and criticisms, has recently adopted a temporary "go slow" posture for bank holding company expansion, its past actions demonstrate that Congressional guidance through the form of clear and mandatory statutory guidelines is needed. The Board's "go slow" policy today can become a wild "go go" policy tomorrow. The new statutory provisions must prevent the Board, or any successor Federal Bank Commission, from allowing bank holding companies to engage in nonbanking activities, such as the sale of noncredit life insurance, which are not directly and necessarily related to banking. Only Congress can provide the needed guidance since the court system has only a limited scope of judicial review and pays great deference to the decisions of regulatory bodies such as the Federal Reserve.

Therefore we strongly urge that the Bank Holding Company Act be amended to halt the continuing expansion of banking interests into the insurance field. As a bare minimum, bank holding companies and their affiliates should be restricted, as they were under the original 1956 Act, to selling only credit life and credit disability insurance, the only forms of insurance that banks can possibly claim to be related to their business.

To our endorsement of the provisions of S. 2721 pertinent to the proposed increased control of bank holding company operations in unrelated commercial areas, we add the suggestion that the Banking Committee strengthen the proposed restrictions in a few respects. We recommend that the Bill's "grandfather" clause be deleted or substantially modified. At the very least bank holding companies owning banks with more than a specified amount of assets should be required, over a defined maximum period such as five or ten years, to divest themselves of any nonbanking subsidiary which is not essential to the operation of its bank(s). Such a phased divestiture would allow those companies ample opportunity to divest an insurance subsidiary without burdensome financial loss. If divestiture is not required, large banking institutions will be able to continue the unfair and perhaps illegal practices that serve as the very basis for the pertinent provisions of this Bill.

We also recommend that the Committee specify, either in the Bill itself or in the accompanying Committee Report, those activities, such as the sale or underwriting of noncredit insurance, which are unquestionably not directly and necessarily related to banking. Given the Board's continuing failure to

⁵ The current regulation does not define the meaning of a "significant portion." An "interpretation" of the Board provides that 5% of the holding company's aggregate insurance premium will generally be acceptable.

⁶ Decision dated January 26, 1976.

regulate effectively the banking industry's participation in nonbanking activities, such a clear Congressional mandate unfortunately becomes necessary to insure that Congress's intent is faithfully fulfilled.

Finally, we urge Congress to act without delay to adopt S. 2721 or similar legislation prohibiting banking institutions from engaging in the sale and underwriting of noncredit types of insurance. Immediate action on this legislation is urgently needed to protect consumers, insurance agents, and small businesses from economic abuse and to protect the public interest by preserving the strength and integrity of banking.

Appendix

LEGISLATIVE BACKGROUND

The current Federal Reserve Board permissiveness in allowing banking institutions to engage in insurance and other commercial activities contrasts sharply with the intent of Congress expressed at the time the first comprehensive legislation to regulate bank holding companies was passed twenty years ago. In enacting the Bank Holding Company Act of 1956, which remains the legislative basis for regulating all bank holding companies, Congress demonstrated a strong desire to prevent bank holding companies from controlling both banks and nonbanking enterprises. To this end, the Act provided that multi-bank holding companies (controlling more than one bank) would be strictly prohibited from engaging in nonbanking activities.

There were, of course, certain limited exceptions to the general rule, the most important of which was contained in Section 4(c)(8) of the Act. It permitted holding companies to engage in certain nonbank activities provided the Federal Reserve, which had responsibility for implementing the Act, determined such activities to be "so closely related to the business of banking as to be a proper incident thereto."

Banking interests found the 1956 Act blocked their profit-oriented goal of engaging in nonbanking businesses such as data processing services, travel services, equipment leasing, operation of commingled trust funds, underwriting and dealing in revenue bonds and securities, and the selling of all types of insurance.

To circumvent the Act's restraints on such nonbanking activities by multi-bank holding companies, banks rapidly began utilizing one-bank holding companies, which were not then subject to the federal regulation. Thus, a bank wishing to engage in a prohibited activity would simply form a one-bank holding company and engage in the prohibited activity through a subsidiary of the holding company. This loophole would have allowed banks to enter any line of commerce, including retailing, manufacturing, mining, or farming, thereby rendering obsolete the Act's legal restraints on nonbanking operations.

In response to the great surge of new one-bank holding companies, Congress began hearings in 1969 on legislation to make the Act's provisions specifically applicable to one-bank holding companies. Recognizing that the one-bank loophole soon would be closed, the banking industry mounted a massive lobbying effort to create a new loophole by modifying Section 4(c)(8) of the Act to broaden the exceptions to the general rule which prohibited bank holding companies from engaging in nonbanking activities.

The 1970 Amendments to the Bank Holding Company Act, enacted after lengthy hearings before both the Senate and House Banking Committee, did extend the Act's provisions to one-bank holding companies. However, while there was some minor modification of the language of Section 4(c)(8), the Amendments appeared to retain the standard of the 1956 Act which limited bank holding companies to nonbanking activities that were "closely related" to the banking business. Thus the amended language required that the activity be "so closely related to banking or managing or controlling banks as to be a proper incident thereto."

The view that the 1970 Amendment in essence retained the prior restrictive test in Section 4(c)(8) of the Act was widely held in the House of Representatives. Thus, Congressman Reuss, now Chairman of the House Banking Committee, explained during floor debate on the meaning of the Conference Report that:

"[T]he conferees clearly rejected the pleas of all those who were asking for the Federal Reserve to be given greater flexibility in interpreting Section 4(c) (8)."

As House members saw it, bank holding companies would continue to be prohibited from engaging in general insurance activities and would only be allowed to sell credit disability and credit life insurance, forms of insurance which the Federal Reserve had treated as "closely related" to banking under the 1956 Act:

"Congressman BROCK." The thrust, then, of the legislative intent of the conferees would be perhaps to allow a continuation of practices such as activities in the credit life insurance field, which are directly related to the banking function, and *not in the field of general insurance whatsoever.*

Congressman REUSS. *Certainly not in the field of general insurance; and with respect to credit insurance, I would say the general lines picked out by the Federal Reserve in its adjudications over the years will probably be continued. After all, they are dealing with the same language, 'closely related to banking.' I would presume that would carry over to interpreting that test.* (italics added.)

By contrast, some Senators, and of course, the banking interests who were seeking a new loophole, argued that the 1970 amendments to Section 4(c) (8) gave the Federal Reserve greater flexibility to allow bank holding companies to engage in nonbank-related activities than had existed under prior law.

In implementing the 1970 Amendments, the Federal Reserve adopted the position of the banking lobby and, contrary to Congressional views such as those expressed by Representative Reuss, treated the current Bank Holding Company Act as giving it greatly expanded power to authorize the entry of the banking industry into nonbanking activities.

The Board's permissive interpretation of the 1970 Amendments to Section 4(c) (8) has resulted in bank holding companies aggressively and systematically expanding into numerous forms of nonbanking activities. At the same time, banks have continued their concentration of the nation's economic power.

The CHAIRMAN. Thanks all of you gentlemen for most helpful statements.

Mr. Schmuck, your position was very helpfully delineated in that letter and I'm glad you read that and read it so carefully and emphasized it as strongly as you did. The key sentence seems to be in explaining what the banker did when he said, "As I indicated to Mr. X, our bank could not accept the loan unless we were allowed to write the credit life insurance." So the customer was not given credit unless he bought credit life insurance from the bank.

Much of your testimony has been based on the thesis that this present situation which the legislation would try to correct—the present situation is inimical to effective competition, what you call freedom of choice.

Mr. SCHMUCK. Yes, sir.

The CHAIRMAN. I think that this is a powerful argument and I think that Mr. Kremer, too, made the argument with respect to credit life insurance.

Can you tell us specifically what other fields of insurance you found that would be particularly subject to unfair competition in addition to credit life? Is that the principal area?

Mr. SCHMUCK. Well, of course, our employment and our target was to determine the effect of the conduct of insurance marketing by banks upon the marketing activities of the agents of insurance companies specifically in the life and disability insurance areas.

Now it became evident to us in the process of this investigation that the same situation as we have defined here with respect to life and disability insurance applies in the general insurance area as well, and Mr. Kremer I'm sure is much more qualified to speak in depth to that point; but we did ascertain that this is an across-the-board problem throughout the entire insurance industry and is not limited to the life and disability insurance industries.

There is one aspect of insurance, however, that at this moment appears not to be touched by the activities of the banks. For some reason, recently the Federal Reserve Board decided that the sale by banks and affiliated corporations of mortgage guaranty insurance was not an appropriate related activity. Again, I'm somewhat puzzled by the reasoning, but that is one exception that has been carved out.

The CHAIRMAN. Let me ask you why the antitrust laws that are now on the books aren't sufficient to provide you with protection? Have you tried to use the antitrust laws?

Mr. SCHMUCK. We have not so far, Senator; no.

The CHAIRMAN. Have your lawyers told you that they would not be effective?

Mr. SCHMUCK. I'm not an antitrust expert, Senator, and I actually have not consulted my partners who practice in the antitrust field. I do know this, however; antitrust proceedings are exceedingly expensive and they are long and drawn out. I'm unable at this moment to give you an opinion as to whether the type of practices that we have illustrated in our statement could become an effective foundation for an antitrust suit, but I would be very happy to submit a judgment for the record.

The CHAIRMAN. We would appreciate that very much.

Now, Mr. Kremer, you indicated that one of the problems is you don't have a completely objective and fair referee. The Federal Reserve Board, after all, is oriented toward the banks. Their constituents are banks. They deal with the banks. They understand the banks. Some of the Governors are former bankers and they are very, very good people, of the highest integrity, but nevertheless, their background would give them the sympathy toward the banks.

You also, I think, indicated the Fed encourages diversification. That is it encourages the banks or the bank holding companies to get into areas not of the kind of strictly banking nature that would seem to be best. Can you document that for us?

Mr. KREMER. Senator, I think—and our lawyers are here—but I believe that you will find documentation of that in the very large summation in the appendices that we have given you and I'm sure if it's not in there we can supplement and give you all the information you need in that regard. Again, as you say, sir, we certainly are not implying anything wrong at all in the way the Federal Reserve Board operates. It's just that they are in constant contact, they are in meetings, they meet with these people and consult with them on a daily basis. We nonbanking people just are not in a position to compete at that level.

The CHAIRMAN. That was my point. I didn't mean to challenge the integrity of the Fed. I have great respect for them. But I think there is that understandable tendency for them to think in terms of the

well-being of the banks and they should, but they go a little far in this case.

Mr. Bobo, one of my concerns is the effect on competition of bank holding company expansion. Could you compare the size of units in your industry with the size of units you would be required to compete against in the banking industry?

Mr. BOBO. Well, the members of our association, which represents the marketing arm of the mainstream of life insurance, are primarily small businessmen such as myself, individuals who are at best two or three people joined together with relatively small operations around the country. We may be affiliated with one or more very large companies at the home office level, but in the marketplace we would be characterized I'm sure as very small businessmen in comparison with the banks in our communities.

The CHAIRMAN. Now we already have the very helpful and specific evidence that Mr. Schmuck gave us with respect to credit life. Is there evidence that the banks are engaging in tying credit allocation to the purchase of other services marketed by the bank holding company?

Mr. BOBO. Yes, sir, I think there's evidence to support that. It's an extremely difficult thing to uncover for the reasons that have already been attested to, and I think that is the great fear of our association, that it is a practice that is growing and one of the reasons that I wanted to make the distinction between credit life insurance, and other forms of insurance of debt. Again, when insurance people talk about credit life insurance they are talking basically about small loans and relatively small amounts of money. Insurance to cover large lines of credit are normally known by other nomenclature and we do see evidence that there are some banks that are beginning to cast a rather strong eye in that direction.

I would also agree with the testimony of Mr. Schmuck that there are a great many reputable banks that have stayed out of that particular market, so I would not want to imply that all banks are doing this. But we see a movement that could be accelerated and that is probably our great fear, unless the practice is curbed.

The CHAIRMAN. Now, is the tie-in overt, direct, that is, in a sense that was provided in this letter where there was obviously no question about it, in which case it seems to me that perhaps legislation simply prohibiting that kind of tie-in might be satisfactory; or is there also a very powerful psychological attitude developed on the part of customers who anticipate that if they're going to get credit in any kind of a tight credit market they'd better patronize whatever else the bank has to sell?

Mr. BOBO. I think there's no question that both of these factors exist.

The CHAIRMAN. Even though we might prohibit making this a tie-in condition on the part of the bank, you still would suffer from the fact that the customers would know that if they wanted to get credit that one way they could do it would be to buy the other services which the bank offered in competition with you?

Mr. BOBO. Yes, sir, that is correct, and I think there's some evidence to support that because the National Association of Insurance Commissioners have attempted to deal with this with anticoercive laws at

the State level and they have been virtually ineffective in the sense that seldom do they get a complaint under these laws because the person voluntarily taking this position does not necessarily feel that he's aggrieved. He's just doing what he thinks is necessary to improve his chances of extending his line of credit.

The CHAIRMAN. Senator Garn.

Senator GARN. Mr. Chairman, I have no questions at this time, but with your great interest in disclosure legislation and conflict of interest lately, I think I ought to make a full and open disclosure to you at this time that I was a member of the National Association of Life Underwriters for 8 years.

The CHAIRMAN. Well, I suppose we have people on the committee who have also been bankers. I worked for a bank but not for that long.

Senator GARN. You can take that into consideration when we get to a markup.

The CHAIRMAN. OK, Senator Stevenson.

Senator STEVENSON. No questions and no disclosures, Mr. Chairman.

The CHAIRMAN. I do have a couple of more questions on the procedural provisions of the bill. How important is it to require the Federal Reserve to adopt regulations and issue orders only after an on-the-record hearing, after opportunity for cross-examination and prohibit ex parte communication by the banks by the Federal Reserve, Mr. Kremer?

Mr. KREMER. I'd like to defer that question if I could to our counsel, Mr. Chairman.

Mr. NEVILLE. Mr. Chairman, my name is John Neville. I'm the general counsel of what used to be the National Association of Insurance Agents.

It's been our experience over a long tedious course of litigation that these matters need to be put on the record so that they can be handled in an expeditious way. The Federal Reserve Board is very technical, as I suppose they have to be, but it makes it a very difficult, costly process to challenge the Board in a formal way. Any procedure that will make the procedure more easily handled by those questioning the Board will be a vast improvement.

The CHAIRMAN. Do they make decisions now based on information not in the record? Is there a feeling that they may be talking to the banks and not to the other competitors?

Mr. WILSON. My name is Tom Wilson. I'm assisting Mr. Neville in this. I'm with Wilkinson, Cragun and Barker and we are Washington counsel for what used to be called the National Association of Insurance Agents.

The IIAA, as it is now known, has a vast amount of experience of what the Board is inclined to do and the fact of the matter is that while we believe that all those people at the Federal Reserve Board and the bankers are honorable men, they go down—after all, the Federal Reserve Board is a bank and they are made up of bankers and they talk to bankers and they go to bankers' conventions and that's necessary. It's part of their job in regulating the banking industry to know the bankers who they are dealing with and to know the operations in which they are engaged. However, that also permits—when an outside party comes in it's very difficult for third parties who are

not regulated by banks to get a fair hearing in the sense that the bankers already have the ear of the Federal Reserve Board just as a function of the symbiotic relationship of the regulatory process. That's not true with outside third parties and for that reason, again, while we're not suggesting that anything untoward has gone on, it's just the atmosphere that's created and it's just part of the process that is a function of the regulatory process.

The CHAIRMAN. That's very helpful. I take it then you feel on the basis of what Mr. Kremer referred to as a sympathetic regulator, that it would be very helpful to have as a corrective for this, on the record hearings and opportunity to cross-examine and decisions made on the basis of the information that has been adduced in an on-the-record hearing?

Mr. WILSON. That's true, Senator, and if I could add just one thing more. The experience that the IIAA has had in the litigation that they have been involved in for years is that, while in a written statement of some sort using such words as "convenience" and "closely related" and "directly related" may indicate one thing, when you get the details of how insurance is written, what kind of coverages we're talking about, under what sort of circumstances, involving certain kinds of loan transactions, or one set of loan transactions as opposed to another set of loan transactions, something different may be indicated. What is really crucial is the cross-examination because when you get beyond the glibness of the words "convenience" and so forth into the details of how it works in the process it's immensely important to examine that through a cross-examination procedure in order that a real perspective be established as to how the thing is going to operate when the banks are actually engaged in the non-banking activity through an affiliate.

The CHAIRMAN. Fine.

Mr. SCHMUCK. I thought perhaps I might add something to this part of the discussion. It's my understanding that prior to the 1970 amendments there was the requirement that each individual application by a bank to embark upon the marketing of insurance, for example, required affirmative findings based upon evidence produced before the Board. By virtue of the interpretations that the Federal Reserve Board has placed upon the 1970 amendments, it is my understanding that an application is granted at the local Reserve Board level if the application falls within the published regulations and rulings on its face and if there is no specific request that a hearing be held to allow for opposition to an individual application. So that as I see it, the pendulum of the regulation has swung from the one extreme in which hearings were required on all applications and during that period the statistics show there were relatively few applications, to the opposite extreme where a hearing must be demanded in order that opposition may be stated.

I would like to add two other things if I might at this point, Senator. Bearing on your question of the attitude of the banker, we included in our statement at pages 9 and 10, a summary of a survey which was made by the Carolinas Association of Mutual Insurance Agents. Those are representatives of mutual nonlife insurance companies. They took a survey in 1973. Of the responses that were re-

ceived from their members, 84 percent stated that the customers of their members who had switched to a bank affiliated agency either felt obligated to buy insurance from the bank or felt that the purchase of such insurance from the bank agency would have a favorable effect on other noninsurance transactions with the bank.

And finally, Senator, I perhaps did not make entirely clear that the illustrative patterns of activity which we summarized at pages 8 and 9 of our statement dealt with the sale of other than what is considered to be conventional group credit life insurance. In other words, each of these summaries dealt with situations in which customers were being urged or required to buy individual life or disability insurance coverage of the ordinary policy type.

The CHAIRMAN. That's very helpful.

Mr. KREMER. Senator, if I may, I think perhaps I can shed some light, too. I have a letter not quite as explicit as Mr. Schmuck's letter, but this one is of particular interest because it happened in my own insurance agency and this letter is written to a salesman who works for our agency by a customer, and I will see that you are furnished with a copy of this letter, also.

I think he was sincere. This is the structural tie-in, Senator. This is the feeling that the consumer had without any pressure or coercion whatsoever. I don't think he had his arm twisted. Honestly.

[Copy of the letter follows:]

JANUARY 7, 1976.

MR. WILLIAM N. HASTINGS, JR.,
HANNA AND KREMER INSURANCE, INC.
Salisbury, Md.

DEAR BILL: The purpose of this letter is to clear up any misunderstanding that may have arisen as a result of the recent changes in our insurance program. We instructed you to discontinue the Automobile Dealer's Physical Damage coverage in the package policy that you have so that we could obtain this coverage through ----- Bank. As you know, ----- Bank does the floor plan financing of our new car inventory.

This in no way indicates dissatisfaction with your service or that of the company, Aetna. As I explained to you, we feel that we have to place this coverage with the bank because we so frequently request special favors of them. Even if their premiums were to prove a little higher, we would still feel obligated in this way.

Please also be assured that this in no way implies that the bank has forced us to make this change in our insurance program. Best wishes.

Very truly yours,

The CHAIRMAN. That was very helpful. That responds very well to the question I asked previously on whether or not it would be satisfactory simply to prohibit a mandatory tie-in on the part of the bank. We still have the very large recognition on the part of the customer that if he wants credit he'd better be a good customer of the bank's other services.

Mr. KREMER. We feel this is more insidious than a direct coercion, obviously.

Mr. BOBO. Could I just add a response very briefly to two questions you addressed to Mr. Schmuck earlier? You raised the question of the antitrust remedies available, and on pages 5 and 6 of our statement submitted for the record we do address this question and we quote

testimony from the 1970 hearings from an Assistant Attorney General of the United States where he defines this as a structural problem and not one of any misconduct. Because of that, there are no anti-trust remedies that would be effective in dealing with this.

Then the other question—are there other forms of insurance other than those connected with credit transactions? I think a good example would be the solicitation by a number of banks through their Master Charge or credit card systems. When a bank sends out a notice that they are offering a low-cost program for their credit card customers, there is an anticompetitive element involved there because in the public's mind a bank is not an insurance company and the public associates banks as being objective noncommercial institutions. Consequently, the public feels if banks say the insurance is low cost then it must be true.

The fact of the matter is, in most instances, it's not low cost and there are many products available that would be far more competitive and we feel that the banks have used their good offices in endorsing products that may not necessarily measure up to the advertising.

The CHAIRMAN. That's very, very helpful.

Mr. Kremer, there's a provision in this bill prohibiting the Comptroller of the Currency from approving an activity of a national bank which the Federal Reserve has denied for a bank holding company. That gets into the problem of "competition in laxity" which you may have heard about between the various regulators.

How important is this provision and would you support S. 2298 which establishes a single bank regulatory agency and abolishes the Comptroller's office?

Mr. KREMER. Sir, I think it is extremely important and the record that you have will show why we feel that way, because we go back to 1962 as far as litigation is concerned. I believe that the record will show that we have indicated support for S. 2298 and if my memory is correct, our trade association has as its policy on record a resolution in favor of your bill, S. 2298.

[The following letter was received for the record:]

SUTHERLAND, ASBILL & BRENNAN
Washington, D.C., April 12, 1976.

HON. WILLIAM W. PROXMIRE,
Subcommittee on Financial Institution, Supervision, Regulation and Insurance,
Committee on Banking, Currency and Housing, Washington, D.C.

DEAR SENATOR PROXMIRE: When I testified on S. 2721 on March 4, 1976, you authorized me, as a response to one of your questions, to submit to the Committee this written opinion as to whether certain practices of bank holding companies and their banking subsidiaries described in my testimony could be made the subject of an antitrust suit.

My testimony described a variety of actions by which banks and bank holding companies have employed their economic power over the granting of credit to enhance the competitive position of their non-banking divisions or affiliated companies in the sale of various forms of insurance. Although such practices are, in my view, clearly unfair and improper, and although many such practices clearly violate the spirit of the antitrust laws, I am advised that the antitrust laws are not an effective mechanism for policing them.

In many cases, a loan applicant is encouraged by a bank to deal with its non-banking affiliate through subtle and indirect forms of coercion which simply do not amount to a violation of the antitrust laws as presently interpreted by the courts. The Sherman and Clayton Antitrust Acts, 15 U.S.C. §§ 1, 14, prohibit, "tie-in" arrangements but only where the availability of one product or service

is conditioned upon the taking of a second product or service. See *ABA Antitrust Law Developments* 38 n. 239 (1975). Where the bank merely recommends or suggests that a loan customer get in touch with its affiliate, or where the bank simply introduces its customer to the insurance affiliate, it would be most difficult, and perhaps impossible, to demonstrate, through legally compelling evidence, that degree of coercion which would be adjudged to be an illegal tie-in.

Even in those cases where the bank explicitly conditions the granting of credit on the purchase of insurance from an affiliated company, an illegal tie-in may not be adjudged unless it is found that the bank had sufficient economic power in the credit market to raise prices or to impose other burdensome terms with respect to an appreciable number of buyers within the market. *Fortner Enterprises, Inc. v. United States Steel Corp.*, 394 U.S. 495, 504 (1969). Parenthetically, there may be a question whether some of the methods by which bank holding companies induce people to purchase insurance from or through non-banking affiliates may be exempted from federal antitrust suits by the McCarran-Ferguson Act, 15 U.S.C. § 1012(b). And finally, although certain of these practices might come within the scope of Section 5 of the Federal Trade Commission Act, banks are in fact exempt from this Act. 15 U.S.C. § 45(a) (6).

Thus, although it is possible that antitrust actions may be successfully prosecuted in some individual cases, it is apparent that such prosecutions alone cannot remedy the pattern of abuses described in my testimony. Antitrust enforcement, therefore, is not in my opinion an adequate substitute for legislative reform.

I shall appreciate inclusion of this letter in the record, and you are assured of my cooperation in responding to any other inquiry concerning the subject matter of my testimony.

Respectfully submitted,

EDWARD J. SCHMUCK.

The CHAIRMAN. Thank you very much.

Well, thank you, gentlemen, very, very much. We appreciate your statements. They are most helpful.

Our next panel consists of Mr. Thomas Owen, president of the Perpetual Savings & Loan Association; Mr. Arthur F. F. Snyder, former president of the Bank of the Commonwealth; and a good friend and constituent of mine, one of my bosses, Bruce Thomas, Mortgage Insurance Companies of America. Apparently, Mr. Owen is unable to be here, so we will start off with Mr. Snyder and then Mr. Thomas.

STATEMENT OF ARTHUR F. F. SNYDER, FORMER PRESIDENT, BANK OF THE COMMONWEALTH

Mr. SNYDER. Thank you, Mr. Chairman.

I have spent the last 20 years in banking, at the National Bank of Boston of which I was executive vice president, and the past 3 years as president of the Bank of the Commonwealth in Detroit.

The CHAIRMAN. So you have a solid banking background?

Mr. SNYDER. Well, I have a banking background. It's nice of you to call it solid.

I am deeply concerned with the soundness and structure of the banking community and anything that anyone does to strengthen that community I am for. For that reason, I am honored to be here today.

I would like to say a few things very briefly that may be fundamental but I hope they are not intended to do anything more than to refresh our memories.

A bank and a commercial business are exactly opposite in their accounting structure. If a group of investors get together to form a commercial business and say collect \$10 million, with that \$10 million

they buy assets and leverage those assets maybe two or three times to one, so that the total structure of the enterprise may be \$30 million based on \$10 million of capital. They leverage those assets by means of debt and other forms of borrowing. That debt follows those assets, something particular to remember.

If, on the other hand, we form a bank with \$10 million, that capital supports a rented facility usually in the beginning and people who conduct themselves in such a manner that they attract deposits through their integrity because deposits are entrusted with them. With those deposits, which are liabilities, they invest in loans and other short-term investments. They can leverage that capital not 2 or 3 times to 1, but 10 and 12 times to 1. It's a much greater leverage.

But fundamentally, the difference between a bank and a commercial business is that in a bank the assets follow the liabilities, whereas in the commercial business the liabilities follow the assets. This may not be *de jure*, but it's *de facto* at least. It's a fundamental proposition which I state from my point of view.

In the last 10 years several banks have gotten themselves into trouble. Most of the troubled banks occur because of controlled ownership or particular ownership by several people. In the commercial banking system, if you create a holding company on top of the bank to compete in ordinary business, the bank suddenly acquires one shareholder instead of many, its holding company. The holding company tends to need profits from that big capital assets, that highly leveraged capital asset, which they use to support either directly or indirectly the other things that they are doing in the commercial sense.

I'm against the banks going over into the commercial area because of several things. First, the banker tends to be traditionally set apart from commerce, to be an observer of the scene, to make judgments on the scene, to lend credit to the scene. He should not be a part of the scene. He should be a professional, a total professional. He is entrusted with the liquid assets of the families and businesses of his community and anything he does to dilute that trust is wrong for the community.

Furthermore, us bankers are lucky if we know enough to run our own banks well, much less run other people's businesses well.

I agree with what has been said before with respect to competition. I do not think that the bank should be in competition. He's using great amounts of leverage. The leverage arises through the deposits of the community. They are not his deposits. He doesn't own them. He's entrusted with them.

In the olden days, the king used to be ascribed a great deal of power and intelligence because of that power. The banker sometimes is ascribed intelligence because he has power. It doesn't necessarily follow. I guarantee it. But he should not be allowed and permitted to move over into the commercial area of the community.

Furthermore, as the inflation increases the need for capital in the bank, the capital is not built at the same level. Therefore, there's a capital shortage. He should not be using that capital shortage over in the commercial area. He should reserve it to protect his own depositors.

Mr. Chairman, I'm grateful to be asked to be here. I have spoken to items which I consider to be fundamental to the banking system. I speak in behalf of the banking system, not against it. I speak in support of the Federal Reserve. I have put my feelings in an article which was printed in the Wall Street Journal 2 years ago. I believe that the Federal Reserve agrees with my concepts and I support the Comptroller of the Currency, the Federal Reserve, and the State banking commissioners in a very difficult job.

Thank you, Senator.

The CHAIRMAN. Thank you, Mr. Snyder.

[Complete statement follows:]

STATEMENT OF ARTHUR F. F. SNYDER, FORMER PRESIDENT, BANK OF THE COMMONWEALTH

The necessity to restrict bank holding companies to activities directly related to banking arises from two reasons. First, the banking system has a limited amount of capital to support the deposits of the bank in the holding companies. Second, there is only so much management expertise in any organization and banking has enough to do to follow and manage the proper lending activities in the bank.

Just as management makes a decision where it is to invest its money, there is also an equal decision as to where a bank invests its management. Traditionally, the middle management of banks has not been highly paid; therefore, bank management is limited to the level of ability for which it is being paid. By expanding activities beyond those directly related to banking, the management of the banks is diffused into areas with which it is not familiar.

In my opinion, the expansion of holding companies into activities, other than those directly related to bank, is fundamentally wrong—because a bank is not in the business of making its shareholders rich. It is in the business of being a trustee for its depositors. When a bank expands its activities into ordinary commerce, it is making an investment decision, rather than a loan decision. Investment risks imply the risk of the marketplace and the loss of the capital committed. Lending risks, on the other hand, imply that certain ratios have been measured before a loan was made and that there are margins to the collateral involved which give reasonable assurance that the loans will be repaid. Gaining the repayment of bad loans is a far different matter than regaining the capital in a bad investment. Therefore, I am opposed to bank holding companies becoming involved in activities other than those directly related to the banking industry.

Banking used to be an industry unto itself. Increasingly, it is becoming only a part of some other vaguely-defined industry. The growth of this form of organization matches anything any other industry has to offer. In 1962 just 442 of the nation's 13,426 commercial banks were part of multiple-bank holding company groups, or less than 4%. The data available for 1972 showed that deposits held at holding company banks had climbed to 61.5% of the nation's total, with most of the recent growth occurring in the multiple-bank classification. Bank holding companies accounted for 73% of all acquisitions of banks at the end of 1973. Analysis of deposits held by large banking institutions during the past 25 years showed that the largest ten had almost 30% of the deposits by 1975.

An entirely new consideration has entered the picture, especially as it concerns the phenomenal growth of the one-bank holding company arrangement. Holding companies can enter new product lines and new geographic markets that would otherwise have been impractical or impossible for their bank subsidiaries to enter.

Perhaps it was only a coincidence that the desire to seek new markets grew at the height of the conglomeratization craze of the late '60s. Or perhaps it was felt that some new lines would be helpful in gaining admittance to the go-go clubs that were very popular on Wall Street at the time. In any event, the one-bank holding company was a truck big enough to drive through the loophole in the Bank Holding Company Act and pick up loads of new markets.

Between 1950 and 1959 only 290 non-bank subsidiaries were acquired or formed by the one-bank holding companies then extant. In the 1965-70 six-year period the number of non-bank acquisitions and formations zoomed to 2,571.

The 1970 amendments brought one-bank companies under the control of the Federal Reserve, which promptly set narrow limits on the non-bank activities in which they could engage. The "grandfather" clauses incorporated into the legislation afforded little protection to any organization the Federal Reserve governors seriously wanted out of unacceptable non-bank activities.

Even with the more stringent regulatory environment, there has been little reason to believe that it will much affect the changing thinking of bank holding company management. Like the businessmen they have become, they are talking about "performance". Many have moved over to the Big Board. They now watch their P-E ratios as closely as any electronics manufacturer used to. Themselves "institutions", they have taken to familiarizing analysts with their growth potential in the hope of becoming the "darlings" of still other institutions. In short, bankers are becoming like everyone else in business and that is where the danger lies.

Bankers are not like everyone else in business. And, for the most part, that's how they have viewed themselves historically. They are affected with the public's interest. They are the guardians of the liquid assets of millions of families and businesses. They supply credit, the lifeblood of the nation's economy.

Banks are recognized in both state and federal laws as quasi-public utilities. They operate under state or federal charters. A charter is a vastly different instrument than a license to do business which is available to all for the asking. As a matter of public policy, the banker is expected to be different from the ordinary businessman. The essence of being a banker is to stand apart from the excitement and to serve business and the community without joining in business activity. The banker, like the attorney and the accountant, acts as an observer and a servant, but not as an active participant.

When the banker's only concern becomes his own profitability, there is a risk that he might lose his objectivity and, thereby, diminish his ability to serve. This is what happened in the 1920s when even men of intelligence and character followed the trends of the times and engaged in practices which unquestionably deepened the Great Depression that followed. How else can one account for practices such as unrestricted loans to almost anyone for carrying securities which fueled the fires of the stock market boom that ended so abruptly in 1929? Or for non-reducing mortgage loans that meant the home owner neither reduced his liability nor increased his equity? Or for the evil practice of "investing" depositors' money as investment bankers invest their own capital? Bankers who were concerned only with their own profits lost the virtue of self-restraint, the very quality they so admired in their customers.

When the holding company needs a shot in the arm for its next earnings statement and leans on the bank subsidiary or subsidiaries to provide it, how well will the public's trust be remembered? How loyal will, or can, the bank's management be to sound banking practices? In a situation where the holding company officials are not bankers—or have forgotten what it is to be a banker— isn't there a danger that prudence might give way to expediency? Bankers establish reserves for loan losses because they know that a small percentage of their customers will have taken too great a risk and the loans will not be repaid. On the other hand, where are the reserves for investment losses to protect the depositors if the banker takes too great an investment risk and loses? Default risk is one thing; the businessman's investment risk is quite another.

The problem lies in the fact that the biggest asset in the holding company, that great profit flywheel—the lead bank—has only one shareholder. And holding company management votes its holdings as one share. The assets of banks are not created by the stockholders investing money as they are in a regular corporation. That corporate capital is turned into assets and additional assets are acquired by leveraging, earnings and more capital.

On the other hand, the major assets of a bank are created when depositors entrust their money to the bank. These deposits are then turned into assets with the bank's capital becoming leveraged as much as ten to one. Therefore, the assets of the bank do not truly belong to the stockholders. Rather, they

belong primarily to the depositors. Neither those assets nor what they earn should be used capriciously to benefit the shareholder at the risk of the depositor.

Another way of saying the accounting of a bank is directly reverse from the accounting of a corporation is that in a corporation the liabilities follow the assets; but in a bank, the assets follow the liabilities. Since it is the depositors' money which is being leveraged, not the shareholders, it is easy to forget that our responsibilities in the banking industry are forever to the depositor. If we make money for the shareholder, we are benefitting the depositor by increasing his protection against leverage.

There can be no banking reason to own a bank. There can be prestige reason or an investment reason, but no banking reason. With 14,000 banks in the country, if an owner cannot get his banking from one of those, he has no right to get it from his own bank. We see this in many of the problem banks of the past decade. Closely owned banks tend to put more pressure on management for higher earnings. Weak management takes greater risks and, in the long run, provides poorer, if not disastrous, results. The result of controlled ownership of banks can be easily seen in the U.S. National, the Franklin National and several others. What may not be recognized is that in the holding companies, particularly the one-bank holding companies, the flagship bank is a big asset whose earnings must provide the income for the holding company. Since that flagship bank has only one shareholder, its parent, it is all too easy to vote for higher risks to gain greater yield. The depositor, the reason a bank exists, has no interest in that goal.

STATEMENT OF BRUCE THOMAS, MORTGAGE INSURANCE COMPANIES OF AMERICA

Mr. THOMAS. Mr. Chairman, I am Bruce Thomas, vice president of the Mortgage Insurance Companies of America and chairman of the Continental Mortgage Investment Corp., the second largest private mortgage insurance company. I'm a resident, as you know, of Madison, Wisc., where I am also a director of the First Wisconsin National Bank and have been for the past 5 years. It's the fifth largest bank in Wisconsin.

I appear here in support of the amendments to section 4(C) of the Bank Holding Company Act set forth in S. 2721 and I appear as vice president of the Mortgage Insurance Companies of America, a trade association made up of 12 of the 13 private mortgage insurance companies. We refer to ourselves as MICA. Our statement has been filed by Mr. Karl, who is president of MICA. He was unable to be here this morning. Mr. Karl is chairman of the Mortgage Guarantee Insurance Co.

There are, as I say, 12 members of our trade association, three in North Carolina, two in California, two in Wisconsin, one in Michigan, one in Georgia, one in Virginia, one in Illinois, and one in Ohio.

MICA is grateful for this opportunity to express its concerns as we are operating in the face of a Federal Reserve Board determination that mortgage insurance is in fact closely related. They have not dropped the other shoe and authorized the bank holding companies to enter into our business. A petition that was initiated early in 1973 was denied in September of 1974.

Let me state first of all that MICA is not antibanking. Banks are customers of ours in the mortgage insurance business. They serve as our transfer agents and as our registrars. They manage our pension funds. They are custodians of our securities for safekeeping. They

give us lines of credit, borrowings, and they make construction loans when we build buildings. Those are all historic banking functions and we are grateful for our business relationship with them as bankers and as customers.

MICA's concern with the bank holding companies was activated on May 23, 1973, when the Federal Reserve Board issued a proposed rulemaking notice that they were thinking of authorizing the underwriting of mortgage insurance as a permissible activity of bank holding companies. After briefs and a considerable struggle, we were able to get the Federal Reserve Board to agree to a hearing. Senator, responsive to the question you asked as to do we favor the procedural aspects of this bill, our answer is, yes, very much so. The due process rights of every opponent of a bank holding company proposing to enter into the commercial area calls for an appealable record. The Federal Reserve Governors should decide on the facts as they have been presented in an open forum with the opportunity for examination and cross-examination.

You asked does somebody that's not a banker feel comfortable going before a bank regulatory authority. Relative to our own feelings, when we were before the Federal Reserve Board, we felt like carpet-baggers in the Holy Land. Members of the Federal Reserve Board staff went to lunch with the bank proponents to get the questions to ask of us while we were appearing as witnesses. I hardly think that's a role of an independent body representing all aspects of the public interest.

I urge the committee to review the testimony in that proceeding on January 24 and 25, 1974, particularly the testimony of independent parties who were not giving self-serving declarations, which I could be accused of giving when I'm a witness in opposition to a bank holding company trying to come into the area. But look at the statements of Professor Rapkin of Columbia University and Professor Graaskamp of the University of Wisconsin. Look at the statement of Jim Barnes, chairman of the Commonwealth Bank in Detroit and chairman of Barnes Mortgage Banking Co. Their statements will give a true and correct picture of the difference between banking and mortgage insurance.

You asked about the relationship of the size of the proponents for bank holding company expansion and MICA. The 30 banks who filed statements in support of the bank holding companies coming into private mortgage insurance had combined assets of \$144 billion. That represented 18 percent of the bank assets in this country. Our companies had total combined assets at the time of \$350 million in opposition. On the other side, as leading proponents, were the three largest banks in the United States, bank holding companies—the Bank of America, Citicorp and Chase Manhattan.

At the hearing, the Bank of America and Indiana National Bank of Indianapolis were the two active proponents.

The CHAIRMAN. We get lost in those figures so easily. You're saying that the size was about 500 times greater on the other side than yours; is that about right?

Mr. THOMAS. That's correct, sir.

The CHAIRMAN. 500 times greater. From that standpoint, I think you very vividly show us the inequality of the competition just from the standpoint of sheer size.

Mr. THOMAS. Also, appreciate that we were playing the game on a court where the referee was a "homer." You understand that?

The CHAIRMAN. Yes.

Mr. THOMAS. Let me say why we were so upset with the proposal that bank holding companies enter our business and describe the grounds on which we opposed the proposal.

First of all, we opposed entry on the ground of conflict of interest; second, on the basis of unfair competition; third, on the grounds that it was contrary to the public's best interest in preserving the historic separation between banking and commerce and; fourth, because it would fragmentize the private mortgage insurance industry into a lot of little regional companies when the essence of insurance is spreading the risk across a wide spectrum of the United States; and fifth on the grounds that bank entry would lead to unsound business practices, some of which have been alluded to by witnesses who appeared before and which have been very neatly outlined in the testimony of Mr. Karl in the form of his written statement which was prepared for this proceeding by Mr. Russell Van Hoosier, an MGIC officer who is the former commissioner of insurance for the State of Michigan, a Harvard business school graduate and a Harvard lawyer, a man that has tremendous understanding of the problems of unsound practice in the insurance business.

I refer to page 3 of Mr. Karl's statement where he cites the Alger report. Back in the 1930's, the private mortgage insurance industry existed and got into great difficulties in the collapse of real estate values in the depression. Governor Herbert Lehman, the Governor of New York, appointed a special committee on private mortgage insurance and the relation of other institutions to it. Alger was a young assistant attorney general and in his report back to Governor Lehman he had this to say:

The business of guaranteeing mortgages is not an ordinary banking function and the public would have been better off if none of the companies had owned or been affiliated with banking institutions, or in turn had not been owned by them.

I point out another factor that I think this august body, the Senate Banking Committee, should be aware of because they have been acutely sensitive to the capital needs of banks during the credit crunch that we have been going through since 1973 and 1974. The mortgage insurance business is a capital consuming business and the last three companies that were started in our business started with initial capital of between \$10 and \$22 million. One of the bank proponents that appeared before the Federal Reserve Board in January 1974 initially proposed that they would enter this business with \$3 million. Then when they found out it would take \$5 million to be qualified to sell loans to FNMA or Federal Home Loan Mortgage Corporation, they increased what they thought they would need to \$5 million. Then when they began to hear the testimony, they thought they would really need \$15 million. So they went from 3 to 5 to 15 in the space of one day's testimony.

The bank holding companies should be prepared to meet bank needs when economic pressures develop of the kind that developed in 1974 when in the fourth quarter we had 14 percent inflation, 9 percent unemployment and a 12 percent prime rate, and they shouldn't be trying to allocate capital that's been put in their bank by little people in the form of deposits and taking the risks that are involved in a high-risk business such as the business we're in, the private mortgage insurance business.

I can remember with some amount of amusement that one of the proponents—and I won't cite which one it was—told the Federal Reserve Board that one of the things they were going to do for the public before they ever spent one day in the business was cut rates. They were going to cut rates on the basis of a loss experience that they were witnessing in the historical past, during 1972 when the rate of unemployment was 4 percent and the rate of inflation was 4 percent and the prime rate was 4.5 percent and our loss ratios ranged between 7 and 10 percent. Those loss ratios, Senator, in the fourth quarter of last year got up to 50 and 60 percent very quickly. We had very high unemployment at the end of the spectrum where high-ratio borrowers have to obtain private mortgage insurance to get a loan the unemployment rate was probably 15 percent. So if that bank had been permitted by the Federal Reserve Board to go into the private mortgage insurance business and cut rates before they even had a portfolio of insurance they would have been in desperate trouble by the end of 1975.

Another thing that I'd like to point out, Senator, is the ripple effect of mortgage finance. The banks are and have historically been very heavily involved in the construction lending business and do a good job. It's short-term lending of the kind that banks are normally committed to where they can stay with the money market and the rises and falls that are part of that money market. But what's been happening with the Bank Holding Company Act is a developer will come in to get the construction loan and pretty soon he's being asked or suggested subtly or otherwise to get his casualty insurance coverage with the bank and maybe that would help in getting the construction loan, to get life insurance coverage, and then when he finishes his project and the permanent investor comes in, the permanent investor may need mortgage insurance in order to get a permanent loan.

Now he's going to get mortgage insurance from the bank. If he's a mortgage banker he's going to be concerned about the lines of credit which he must have to survive. All of these things have a ripple effect or a tie-in effect. Then if he's successful with the whole project the bank will lease him a car and let a travel agency make the arrangements for him to take a vacation to celebrate his victory. So they've got the project covered from A to Z, as the rent-all agency states.

Banking and commerce should be separated. They will both be better off. The public is better off if the deposit dollars that are received in trust are allocated for historical conservative banking risks and not directed into the high risk area of the business world, as was so credibly stated by the witness preceding me.

The pressure for growth, once the bank gets involved as a bank holding company, to develop a track record, to develop the additional capital to keep this treadmill going, encourages bank holding companies in getting into higher and higher risk businesses. That's what propelled them into the REIT business. They got into this high yielding form of mortgage finance and many of them got into trouble because of it. I can remember with some amount of humor how I was scolded by one of the members of the Federal Reserve Board Governors when I was testifying about the dangers that I could see coming for the bank holding companies that owned REIT's. This was in January 1974 just before the tip of the iceberg broke to the surface. This particular Governor said to me, "Mr. Thomas, you're a lawyer. You understand the difference between a bank holding company and the bank. The banks are nothing but managers of those REIT's."

The CHAIRMAN. What Governor was that?

Mr. THOMAS. That was Governor Sheehan, who was incidentally from Edgerton, Wis.

The CHAIRMAN. I knew there was something good about him.

Mr. THOMAS. But he said to me, "You understand the legal difference." I said, "Yes, and it's a legal fiction." In the minds of the investors in the REIT's they think they are investing in the bank and that one bank that I was talking about took \$14 million of their bank's capital and put it over to cover the crash of their REIT within 6 months of my testimony, and the legal fiction just disappeared. And that same thing would happen in our business if we had a collapse in real estate values. The banks that were in the mortgage insurance business would suddenly find their mortgage insurance companies needing additional capital to cover losses.

So in closing, Senator, I would urge and reiterate in the strongest terms possible that the Federal Reserve Board has concluded that the mortgage insurance business is closely related to banking and presumably a permissible activity of bank holding companies. I pointed out the disadvantages to the public of such an entry and the amendments set forth in section 301 of the Senate Bill 2721 should bar entry. MICA strongly recommends its approval by the committee and the Congress to avert any final ruling by the Board that would generate conflicts of interest and have an adverse impact on the home buying public and the banking community.

Thank you.

[Complete statement of the Mortgage Insurance Companies of America follows:]

STATEMENT OF MAX H. KARL, PRESIDENT, MORTGAGE INSURANCE
COMPANIES OF AMERICA

Mr. Chairman and Members of the Committee: On behalf of the Mortgage Insurance Companies of America¹, I am pleased to present this statement in

¹The Mortgage Insurance Companies of America is a trade association consisting of twelve private mortgage insurance companies whose insurance in force at the beginning of 1976 was in excess of \$40 billion. The national officers of the Association are Max H. Karl, (Chairman, Mortgage Guaranty Insurance Corporation, Milwaukee) President; Bruce Thomas (Chairman, Continental Mortgage Investment Corporation, Madison), Vice-President; John E. Horne (Chairman, Investors Mortgage Insurance Company, Boston), Treasurer; William Hemphill (President, United Guaranty Corporation, Greensboro, N.C.), Secretary; and John C. Williamson, Washington, D.C., Executive Vice President.

support of proposed amendments to section 4(c) of the Bank Holding Company Act, as set forth in Section 301 of S.2721, which would provide stronger and more restrictive tests in determining whether a bank holding company may engage in certain non-banking activities.

The mortgage insurance industry is directly involved in the issues presented by the legislation. On May 23, 1973 the Federal Reserve Board issued a notice of proposed rulemaking the underwriting of real estate mortgage guaranty insurance was a permissible non-banking activity of bank holding companies. Subsequently, in January 1974 public hearings were held on the applications of three bank holding companies for de novo entry in the mortgage guaranty insurance business. On September 11, 1974 the Board denied the applications "at the present time" although concluding that underwriting mortgage guaranty insurance "is closely related to banking" and therefore in principle a logical and legal activity for bank holding companies.

It is our considered opinion that the Federal Reserve Board having ruled that mortgage guaranty insurance is "closely related to banking or managing or controlling banks as to be a proper incident thereto" that this is sufficient and eloquent testimony that the test, quoted above, requires the amendments proposed by section 301 of S.2721, that the activity sought be "closely and directly" related to banking, and that the activity be "a proper and necessary incident thereto."

If the 'closely related' test makes mortgage insurance a permissible activity, then the test must be revised to require that the activity be "closely and directly related to banking" as provided in S.2721.

Our arguments as herein set forth will point out the reasons why bank holding companies should not be permitted to engage in mortgage insurance. This will underscore our argument why Section 301 of S.2721 should be approved so as to avert such a ruling by the Federal Reserve Board.

The underwriting of mortgage guaranty insurance may be "related" to banking in the sense that banks originate mortgages on real estate. At that point the interest of the bank as lender, and that of the mortgage insurer, move off at divergent angles.

First a little history. The private mortgage insurance industry which flourished in the early decades of this century went broke in the early 1930's. A New York State Commission investigated the debacle and concluded:

"The business of guaranteeing mortgages is not an ordinary banking function and the public would have been better off if none of the companies had owned or been affiliated with banking institutions, or in turn had not been owned by them." (*Alger Report*, P. 86)

If the present tests for acquisition or *de novo* entry by bank holding companies in mortgage guaranty insurance were to result in approval by the Board, the following conflicts of interest with inevitable detriment to the public interest would result:

1. ELIMINATION OF RECIPROCAL POLICING

The relationship between mortgage insurers and lenders today is subject to the discipline imposed by the competing interests of independent businesses with differing viewpoints. Where the mortgage lender and mortgage insurer are unrelated, there is a salutary of incentive for reciprocal policing of both lending and insuring practices. The mortgage lender will seek an insurer whose rates and services are competitive and who possesses sufficient financial strength and risk dispersion to assure its ability to satisfy its insurance obligations. At the same time, the insurer will seek to avoid underwriting lenders whose practices expose it to high risks of loss. Affiliation of the lender and insured would relax or eliminate entirely the incentive for such mutual policing. This result seems obvious in cases of providing coverage for the credit risks of lending affiliates.

Conflicts may also exist whenever an insurance subsidiary underwrites mortgage loans originated or held by a mortgage lender with significant business contacts elsewhere in the holding company system. Thus, a mortgage banker or a commercial bank which borrows from or has significant deposits in a banking subsidiary within the holding company may be in a position to command special treatment from the holding company's insurance subsidiary,

The opposite could, of course, also be the case—that is, such a customer might feel constrained to purchase the holding company's mortgage insurance because of favorable credit relationships. It is the malign influence such relationships may have on underwriting practices and standards which are cause for greatest concern.

2. ADVERSE RISK SELECTION

A favorite banking customer of the holding company system may be granted insurance on mortgage loans which, but for the banking relationship, would have been rejected by the mortgage insurer. The ubiquitous hazard of adverse risk selection always prevalent in the mortgage insurance business, and indeed any insurance business, will be greatly exacerbated by the presence of extraneous incentives for an insurer to accept (or fail to investigate adequately) risks proposed by a preferred customer of its banking affiliate.

3. APPRAISAL PRACTICES

Faulty appraisal practices pose an even graver potential problem than adverse credit risk selection. Mortgage guaranty insurers generally rely upon the property appraisals submitted by their lenders (spot checking by means of independent appraisals). Inflated appraisals expose the mortgage insurer not only to normal fluctuations in property values but also to an initial inadequacy of security which virtually assures loss in the event of default.

4. HIDDEN REBATES

To persons unfamiliar with the insurance industry, it may not be self-evident how damaging hidden rebates can be. State insurance regulations generally prohibit rebating of premiums; and the Federal Home Loan Mortgage Corporation's eligibility requirements for mortgage insurers expressly prohibit paying commissions or other compensation to insured lenders or persons related to them (FHLMC, Eligibility Requirements S.150). The principal objective of these regulatory prohibitions is to prevent unfair discrimination between insureds and provide assurance that premiums are sufficient to cover the insured risks. Allowing affiliation of banks and insurer will greatly facilitate circumvention of these salutary state and federal regulations.

5. FINANCIAL RELATIONSHIPS

The existence of other financial relationships within the same holding company would create an excellent vehicle for covert premium rebates. A bank holding company might indirectly compensate a customer of its mortgage insurance subsidiary by having its banking affiliate make deposits in or reduce correspondent service charges to such customer. Even more obvious opportunities for premium rebating exist whenever the insurance customer is also a borrower from the banking system, e.g., interest rate reductions or more favorable loan terms. There are times that the mere availability of credit when it would not otherwise be available could be considered a rebate.

The intricate web of reciprocal relationships which exist in the correspondent banking area would make rebates almost impossible to discover or police.

The crucial point is that there is no conceivable way to prevent, much less police, such rebating if significant financial relationships with non-insurance subsidiaries of the holding company are allowed to exist. It would not be feasible to determine that excessive deposits are being made by a holding company bank with correspondent banks which are also customers of its mortgage insurance affiliate or that the interest rates on loans to a mortgage banker have been slightly reduced to compensate the mortgage banker for using the holding company's mortgage insurance.

6. REINSURANCE

Another danger is the possibility that the mortgage insurance affiliate of a bank holding company will reinsure its risks with a thinly capitalized reinsurance affiliate of a banking customer of a holding company. Reinsurance can easily be used to disguise premium rebating.

If the lender who controls the flow of insurance business also owns a reinsurer, the lender can require the primary insurer to reinsure with the lender's

affiliated reinsurer. Since reinsurance premium rates are not regulated, the reinsurer can charge any price it wants. If the primary insurer wants to keep that lender's business, it will have to pay the price. This type of rebating through the reinsurance mechanism has existed in the credit life and credit accident and health field for several years. It has proved to be almost impossible to regulate or control this type of rebating activity. Such rebating has potentially disastrous consequences because the primary insurer has fewer funds because of the high reinsurance premium and, since the reinsurer is usually distributing its profits, it may not have the funds available to meet its obligations.

7. INADEQUATE GEOGRAPHIC DISPERSION OF RISKS

Another danger inherent in allowing mortgage insurers affiliated with bank holding companies to insure customers of the holding company banks is the adverse impact on geographic dispersion of mortgage insurance risks. Because even the largest bank holding company banks are essentially regional in their operations, it will be natural for bank holding companies to place greatest emphasis on marketing mortgage insurance in the regions where their banks have established markets—that is, where their reciprocal leverage to sell mortgage insurance derived from the banking relationships will be the greatest. Confining risk dispersion to a limited geographic area is extremely undesirable from an insurance standpoint, because it makes the insurer peculiarly vulnerable to economic reversals affecting only that region.

8. UNNECESSARY INSURANCE

The decision to purchase or require mortgage insurance (like credit life and credit health and accident insurance) is made by the lender, not the borrower who in one form or another pays for it. In a normal arm's length situation, competitive interplay among lenders may prevent their requiring borrowers to maintain mortgage insurance except where it is clearly needed from a credit standpoint. The existence of other relationships, such as correspondent banking or a mortgage lender's own borrowings from the banking affiliate of a mortgage insurer, may, however, cause the mortgage lender to insist on mortgage insurance for reasons which have no connection with the mortgage loan transaction. Particularly in the case of commercial banks (which tend to treat residential mortgage lending as an "off-again, on-again" proposition), it is likely that there will be a strong tendency to require mortgage insurance whenever it would be of advantage to the bank for other reasons.

9. REVERSE COMPETITION

The premiums charged for credit life and credit accident and health insurance are not subject to normal competitive disciplines. Indeed a reverse competition prevails with credit insurance: The stronger the competition for such insurance, the higher the premiums become because larger "experience" rebates, dividends, commissions or other means are offered as a means of compensating lenders who dictate the purchase of such insurance but do not pay for it. In the case of credit life and credit accident and health insurance, however, a lender may not explicitly require a consumer borrower to purchase such insurance from an affiliated company, even though this is often what happens as a practical matter. Even this minimal safeguard against unnecessary and unduly expensive insurance may not exist in the case of mortgage insurance.

10. THE "INCREASED COMPETITION" ARGUMENT

It has been alleged that the share of the mortgage guaranty insurance market of Mortgage Guaranty Insurance Corporation (MGIC) is indicative of the fact that there is a lack of competition. As was noted above, the mortgage guaranty insurance industry as it exists today is a relatively new phenomenon. After its formation in 1957, MGIC had 100 per cent of the market written by private companies until competitors were formed. However, even at that point in time, MGIC was competing with the FHA and VA programs. As competitors have entered the market, MGIC's share dropped to 82 per cent in 1963, to 57 per cent in 1973 and below 50% in 1975. These figures are indicative of the fact that competition does exist and is growing.

11. THE "ADDITIONAL CAPITAL" ARGUMENT

It has been alleged by the bank holding companies that their entry into the mortgage guaranty insurance field would bring increased capital into a business that is very capital intensive. Since the existence of the mortgage guaranty insurance business, it has succeeded in raising capital of several hundred million dollars. The figure as of December 1975 was approximately \$450 million. Thus, while mortgage guaranty insurance is a capital intensive industry, the companies that are in the field have been able to raise funds in the money market when that was necessary.

12. THE CURRENT FUNCTION ANALOGY

Another allegation of the bank holding companies is that mortgage guaranty insurance is so analogous to the credit function of lending money, that it is well within their existing scope of expertise to engage in this activity. This assertion misses the point entirely that the expertise needed for insuring is substantially different from the expertise needed to write insurance even though there are some similar criteria involved.

A lending institution does not make loans on the theory that those loans are going to go into default. Credit is extended only to those individuals or corporations that they believe will pay off the debt. Contrariwise, mortgage guaranty insurance is written on the assumption that there will be losses and that the mortgage guaranty insurance company will have to be able to pay off loans which have defaulted. Therefore, it is important in the insuring function to have an actuarially sound reserving system and a geographically spread book of business. While most lending institutions concentrate in one particular area of geographic expertise, an insurance company must spread its risks geographically so that it cannot be decimated by the economic conditions in one particular area. Consequently, the function of extending credit is a very different one from the function of insuring against default of credit.

To summarize, there is no need for entry of bank holding companies into the private mortgage insurance field to assure competition or to contribute capital for expansion. Nor do bank holding companies possess any special expertise or other assets peculiarly adapted or adaptable to mortgage insurance underwriting. Hence, no gain in efficiency or convenience to the public could be expected to ensue. Indeed, as pointed out above, the relationship would give rise to a strong incentive to foist unnecessary mortgage insurance upon the borrowing public and would invite insoluble conflict of interest situations to the detriment of the mortgage insurance industry. The mistakes of the past indicate that it is important to retain the checks and balances which exist today and which preserve the integrity of the industry.

Furthermore, it clearly would be a mistake to superimpose a capital demanding activity such as mortgage insurance in a banking system which already has demonstrated extreme trauma from capital shortages.

I want to reiterate in the strongest terms that under existing law, the Federal Reserve Board has concluded that mortgage guaranty insurance is closely related to banking and presumably a permissible activity of bank holding companies. In this statement I have pointed out the disadvantages to the public of such an entry. The amendments set forth in section 301 of S. 2721 would bar such entry. We therefore strongly recommend its approval by the Committee and the Congress to avert any final ruling by the Board which would generate conflicts of interests and have such an adverse impact on the homebuying public and the banking industry.

The CHAIRMAN. Well, thank you both very much for two powerful and effective statements here.

Mr. Thomas, you speak for MICA?

Mr. THOMAS. Yes.

The CHAIRMAN. I particularly appreciated your reference to the referee being a "homer." It's almost as if the referee was the mayor of the hometown, the city in which the hometown high school was playing. Now, he tried his very best, but he's got to remember his constituents.

Mr. Thomas, this bill contains a provision requiring bank holding companies and all of their subsidiaries to be adequately capitalized. In your experience, are your bank holding subsidiaries competitors more highly leveraged than you are? I realize they are not actually competitors now. I should say potential competitors or people who might get into this area.

Mr. THOMAS. Well, I really can't address that. We are a highly leveraged business. Under the insurance rules that govern us, we are permitted to have a risk ratio of capital and surplus to risk outstanding of 25 to 1. We try and stay well within that particular ratio. Our particular company maintains a ratio of capital and surplus of 18 to 1. That's a pretty heavy ratio.

The CHAIRMAN. Well, that ratio is less than the big banks have. The big banks, we noticed the other day, their capital ratio is around—well, let me put it this way—their capital is less than 5 percent, averages around 4 percent, of their assets. So their leverage is very strong. In your case, as you say, you're an unusually highly leveraged operation.

I take it, Mr. Snyder, that you now represent—I'm a little confused because you have been president of a bank.

Mr. SNYDER. I resigned as president of the Bank of the Commonwealth on February 1 of this year.

The CHAIRMAN. Are you affiliated now with—

Mr. SNYDER. I'm chairman of the board and chief executive of MPB Corp., Keene, N.H.

The CHAIRMAN. What does that corporation do?

Mr. SNYDER. It makes precision ball bearings and other manufacturing items.

In support of Mr. Thomas, the way this thing gets wrapped around, the ripple effect, I believe you're still part of CMI, are you not?

Mr. THOMAS. I hope so.

The CHAIRMAN. He's the chief executive officer.

Mr. THOMAS. That's not the one of Boston, however.

Mr. SNYDER. OK; I was confused in what your representation was.

Mr. THOMAS. CMI of Madison, Wis.; not Boston, Mass.

The CHAIRMAN. We are proud and happy to hear you say that.

Mr. SNYDER. Because doesn't CMI of Boston have a mortgage company that they're trying to sell?

Mr. THOMAS. They do not, but the principal owners of CMI of Boston, the Wallaces, are also heavy stockholders of CIC Corp. of Boston that does own Investors Mortgage Insurance that is now really in effective control of 16 banks that include some bank holding companies.

Mr. SNYDER. That's why I was a little confused, but it's pertinent because I have been trying to sell that insurance company because they owe us money and it's not been effectively repaid and that's where you get into the circle—begins to meet. There's \$65 million owed to several banks, of which the Bank of the Commonwealth has \$4.2 million, and we meet ourselves coming and going.

Mr. THOMAS. That's right.

Mr. CHAIRMAN. Could I ask you, Mr. Snyder, what's been the effect in your judgment on bank management of expanding into nonbanking activities?

Mr. SNYDER. Well, my judgment would have to be very subjective, Mr. Chairman. I would think that he had dissipated our talents and our abilities into other things rather than the basic banking business. Had we paid strict attention to our responsibilities, maybe we would not have been invested so heavily in the REIT's. Maybe we would not be in some tanker loans and some things of that sort. I think the management of a big conglomerate or congeneric, as they would want to call it in the banking system, is another talent from the banking business.

The CHAIRMAN. Well, you conclude that bank managements have been spread too thin because of this process?

Mr. SNYDER. Yes, sir, I think that one of the problems with bank management was that all through the 1930's and 1940's very few people entered the banking business and therefore we had few people in the 60-year-old bracket who had the wisdom and the experience to look at what's gone on. We have a problem in the banking community today which I think comes from lack of experience and often from youth controlling banks. Youth is still too young by definition. I hope that doesn't offend people, but in the banking business maturity and having been there before are important values.

The CHAIRMAN. Could I pursue with you, Mr. Thomas, a little bit the reference you made to REIT's? I thought that was very interesting because I think all of us recognize the difficulty that our banks have gotten into because of the real estate investment trusts and the holding companies. Did the regulators, in your judgment, allow too much leveraging to take place and should the Federal Reserve have permitted bank holding companies to get into the REIT's business in the first place?

Mr. THOMAS. I think, Senator, you put your finger on one of the very difficult problems. Banking in itself is a technical business and a complicated business and people auditing banks have to understand a great deal about many things as they evaluate delinquent loans to determine whether they should be on a list of delinquent loans that make them a very bad loan that will force whoever the auditor is to make a determination that the banks should have more capital or that the banks should do certain things relative to the leverage of its loan outstanding, capital and so on. And now if you add to the task of people making an audit of the bank to determine its soundness a whole scatter of things that include REIT operation, private mortgage insurance company, a lease car company, a travel agency, a mortgage banking operation, you're putting an unholy burden on those auditors to make assessments and determinations relative to the soundness of the basic business of the holding company which is banking.

Now that carries right on up the ladder all the way to the Federal Reserve Board. The staff of the Federal Reserve Board has historically come out of banking business and that's as it should be. They should understand the business they're regulating. And suddenly if they are thrown into evaluating a whole lot of unrelated commercial businesses, high-risk businesses that they haven't got any depth of experience in evaluating, they are being asked to make judgments as regulators that are very, very precious judgments. They are susceptible to being influenced by the self-serving declaration of the pro-

ponent who obviously wants to go in that business or he wouldn't be before the Federal Reserve Board asking that it be added to the laundry list of things that bank holding companies should do.

The CHAIRMAN. Then should bank holding companies be proscribed from getting into REIT's?

Mr. THOMAS. Well, with the benefit of hindsight, I would certainly have to say yes.

The CHAIRMAN. What effect—in your view—what economic effects would that have? Of course, we all recognize the great benefit that would have to a number of our biggest banks, if they hadn't gotten involved, but would that have had an adverse effect in the future on the availability of capital for real estate development?

Mr. THOMAS. No, sir, because there were a lot of REIT's that had nothing to do with banks that were formed, but people paid their money and took their chances based on a commercial enterprise. For example, the one that he referred to was founded in 1962. Continental Mortgage Investors was initially a very highly successful REIT and its stockholders have been, I'm sure, disappointed with the results during the collapse of real estate values of the last 2 or 3 years. But, they, along with other REIT's, have nothing to do with banking. People paid their money and took their chance. They were not depositors, little people taking their money to banks and putting it there in trust thinking they were going to earn their interest or have their money when they retired and thinking that that very handsome solid structure that they see every day when they take the bus downtown was going to be there tomorrow and tomorrow and tomorrow, operating successfully and conservatively and not that their money was to be transported 2,000 miles away and put into condominiums or shopping centers or factories.

The CHAIRMAN. Well, the principal victims of this REIT have been the stockholders of the banks. The depositors haven't lost money. If they have, it's been very, very rare and in none of the big banks have the depositors lost money.

Mr. THOMAS. Except put yourself in the position of a stockholder of a bank that's had its capital depleted by the bank having to go over and cover the losses of a REIT that sold its stock to people, an independent group of people that paid their money and took their chances, and a lot of those bank stockholders are upset and angry. Their book value per share has been reduced substantially by that transfer of their assets to a REIT that the bank was affiliated with.

Mr. SNYDER. Or a mortgage broker company or other companies. The problem with the bank in the commercial business, the bank is expected to live by its word and if it runs a commercial business people dealing with that business consider that the bank's word is good. I'm not talking *de jure*. I'm talking *de facto*. That implication causes the bank to transfer that capital to support its word.

Mr. THOMAS. The label of a bank on a business gives the Good Housekeeping stamp of approval to it because the bank had a long historic period of time building a reputation and surviving good times and bad times and always being there when people needed money for unexpected illnesses or their children to go to college and so on. And in the minds of the people of a community that bank is

solid and it has an image and to threaten that image by getting banks into commercial businesses is what's so dangerous.

The CHAIRMAN. You see, on the other side, they argue that the depositors are protected by insurance and by the ability of the Federal Reserve to come to the rescue of the big depositors whose deposits may be too big to be covered by insurance and that the bank investor, the bank stockholders become sophisticated enough to recognize that after all he is a stockholder and particularly in recent years, particularly in the last year or so when there have been a number of failures and a number of bank stockholders have had a very sharp drop in the value of their stock, they have become aware of the fact that they are taking a risk and that's the nature of the free enterprise system.

Well, let me ask each of you gentlemen, there's a provision in the bill prohibiting—I asked Mr. Kremer this and maybe you can help me with this, too. Mr. Thomas, there's a provision in the bill prohibiting the Comptroller of the Currency from approving an activity for a national bank which the Federal Reserve has denied for a bank holding company. That's because we have had some problems with the regulation by the Comptroller.

How important is this provision and would you support S. 2298 which establishes a single bank regulatory agency and abolishes the Comptroller's office?

Mr. THOMAS. I would certainly think it's in the public interest to eliminate the dual regulation there at the Federal level. I think that one or the other could do the job adequately and certainly with the staff reputation of the Federal Reserve Board and its banking system it would probably be the more logical place for that regulation to exist. The duplication is at times, I'm sure, confusing to bankers as well as to the public at large.

Incidentally, Senator, before I forget, I certainly want to say that our written statement we want to be included in the record of this proceeding.

The CHAIRMAN. Yes; by all means, that will be done.

Mr. SNYDER. It's a difficult thing for me to answer, having worked for two major national banks and one major State bank, the State banks being regulated by the Federal Reserve and the State banking commissioner. I see regulation in two forms. First, is the regulation controlling and looking at the assets of the bank and how we have managed them, and the second is controlling what businesses we go into. The Comptroller of the Currency certainly does a very fine job in policing the assets of the banks under his control. I believe that there is good competition between a national system and a State system, two banking systems, but I believe that three agencies regulating—the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve Board—perhaps is a little much.

The CHAIRMAN. Very good.

I'd like to ask you finally, Mr. Thomas, the bill would amend the Bank Holding Company Act by restricting the so-called nonbanking activities of bank holding companies to those which are directly related to banking and for which specific public benefits are shown.

Now a problem there—I think that may be the best we can get through the Congress—through this committee and the Congress, but the problem is you still have the hometown referee deciding what's directly related. It's not a laundry list and I wondered if you would like to address yourself to the adequacy of that provision and whether it can be strengthened.

Mr. THOMAS. It will be difficult, Senator, and it will change as the Board of Governors change for the Federal Reserve Board, but it's a step closer to having a better handle on selecting what kinds of activities the banks should legitimately be involved in.

Obviously, I would prefer a laundry list from the Congress. I agree that the politics of that are probably difficult, if not impossible and that this language is probably the closest that we can move in the direction of a laundry list.

The CHAIRMAN. Gentlemen, thank you very, very much, for your most helpful testimony.

The committee will stand in recess until tomorrow morning at 10 o'clock.

[Whereupon, at 11:55 a.m., the hearing was recessed until the following day, March 5.]

[The following statement from the New York Stock Exchange was received for the record:]

STATEMENT SUBMITTED BY THE NEW YORK STOCK EXCHANGE

S. 2721 would amend the Bank Holding Company Act and the Bank Merger Act to restrict the activities in which registered bank holding companies and their affiliates may engage and to control the acquisition of banks by bank holding companies and other banks.

The New York Stock Exchange supports the adoption of sections 301(a) and 401 of S. 2721 to provide more restrictive and specific standards to be applied in determining whether bank holding companies and their subsidiaries may engage in non-banking activities, as a desirable step to curb further concentration of economic power and conflicts of interest in banks and bank holding companies and thereby encourage more effective competition. The standards proposed in S. 2721 appear to make it clear that bank holding companies and their affiliates would not be permitted to operate automatic stock investment plans or engage in the general stock brokerage business. To minimize any controversy over interpretation of the standards it might be desirable to further amend the Bank Holding Company Act to specifically prohibit bank holding companies and their affiliates from operating automatic stock investment plans or engaging in the general stock brokerage business.

The securities industry is in a somewhat different position from other industries in that the Glass-Steagall Act already prohibits banks from engaging in certain specified types of securities activities but authorizes them to engage in certain limited securities activities.¹ The Federal Reserve Board generally has followed those provisions of the Glass-Steagall Act in determining what are permissible activities for bank holding companies and their affiliates. However, the Comptroller of the Currency has generally taken a permissive position in allowing banks to intrude into non-banking activities. As a result, banks are currently engaging in non-banking securities activities, contrary to the intent of the Glass-Steagall Act.

There are a number of important reasons why bank holding companies and their affiliates should be prohibited from engaging in securities activities. These include undesirable concentration of economic power and conflicts of interest.

¹ Permissible securities activities include underwriting and dealing in municipal general obligation bonds and purchasing and selling securities without recourse, solely upon the order, and for the account of customers.

(1) THE CONCENTRATION OF ECONOMIC POWER IN BANKS AND BANK HOLDING COMPANIES

The concentration of bank deposits, assets and (through their trust departments) ownership of common stock in a relatively small number of banks and bank holding companies is viewed with increasing alarm. At the end of 1973 total bank deposits exceeded \$698 billion, with bank holding companies controlling 71% of that amount (\$492 billion) and the 10 largest banking institutions holding 29% of that amount.² Trust departments holds approximately \$350 billion of assets in various fiduciary capacities for the benefit of individuals.³ Seven large New York banks in 1972 collectively held:⁴

17% of the common stock of Mobil Oil.⁵

11% of the common stock of Ford Motor Co.⁶

12.9% of the common stock of Union Carbide.⁷

20% of the common stock of United Aircraft.⁸

19.8% of the common stock of Xerox Corporation.⁹

30% of the common stock of American Airlines.¹⁰

17% of the common stock of Safeway Stores.¹¹

In addition to the basic problems inherent in the concentration of economic power in banks and bank holding companies is the opportunity it provides for tying arrangements whereby banks require a customer utilizing one of its services also to use one or more of its other services. For example, an article in *The Antitrust Bulletin* states:¹²

"The use of tying arrangements to evade such price regulations is not new in banking. 'Compensating balance requirements' were used as early as the 1920's if not before. A 'compensatory balance' is a deposit or minimum balance which a borrower is required to maintain at the bank from which he borrows. Its effects are often to raise the effective charge on loans by requiring borrowers to purchase its certificates of deposit at lower interest rates—either lower than could be obtained at another bank or, more probable, lower than could be obtained on another money market instrument."

A much broader range of tying is suggested in "*The Banking Systems A Preface to Public Interest Analysis*":¹³

"The abuses that arise out of tying relationships in ordinary banking activities may be unfortunate but, once holding companies become involved, potential abuses multiply markedly. A bank subsidiary of a diversified holding company has many more opportunities and motivations for encouraging tying relationships than does a typical independent bank. The situation involving holding companies was succinctly described by the House Committee on Banking and Currency:

'Because many large and small businesses, as well as individuals, depend on bank credit for their economic existence, bank subsidiaries of one bank holding companies are in a position to insist or "strongly suggest" that if the borrower wants continued access to bank credit, (he) . . . should also use the services of the holding company's other subsidiaries. These services might include in-

² Remarks by Senator Proxmire when he introduced S. 2721 on December 1, 1975, Congressional Record of December 1, 1975, p. S. 20790.

³ Testimony by Ray F. Myers, President of Trust Division American Bankers Association, before Securities Subcommittee on Senate Committee on Banking, Housing and Urban Affairs, December 10, 1975.

⁴ Disclosure of Corporate Ownership, December 27, 1973. Prepared by Subcommittee on Intergovernmental Relations and Budgeting, Management and Expenditures of the State Committee of Government Operations. Data are based on responses to an inquiry from Senator Lee Metcalf. Holdings by trust departments of banks and other financial institutions indicate aggregate holdings without any indication as to the voting power inherent in such holdings.

⁵ Id. at p. 30.

⁶ Id. at p. 35.

⁷ Id. at p. 39.

⁸ Id. at p. 44.

⁹ Id. at p. 45.

¹⁰ Id. at p. 56.

¹¹ Id. at p. 106.

¹² Franklin Edwards, "Tie-in Sales in Banking and One-Bank Holding Companies," *The Antitrust Bulletin*, Fall, 1969, p. 587.

¹³ "The Banking System: A Preface to Public Interest Analysis," prepared by the Public Interest Economics Center, Washington, D.C. February 1975, p. 208.

insurance, equipment leasing, property management, accounting, computing, investment and travel services, or any other business the holding company might decide to undertake. This would create unfair competition for non-bank related competitors of these subsidiaries and could in the long run substantially reduce or eliminate competition in many businesses to the detriment of the public interest.' (Brackets added.)" (Staff Report, "The Growth of Unregistered Bank Holding Companies—Problems and Prospects", for the House Committee on Banking and Currency, February 11, 1960.)

The concentration of investments by a relatively small number of institutions, principally banks and affiliates of bank holding companies, is in a relatively small number of favored companies. This concentration of investment in the favored few companies is a natural development, as banks are not much different than most other investors in that their capacity to follow investment developments is ordinarily limited to a small number of the total universe of available investment type stocks. Nonetheless, the combination of the enormous concentration of investment funds with the investment being made in a small number of favored stocks, has apparent adverse impacts on the unfavored majority.

Thus, as Chris Welles observed in an article, "Are the Big Banks Getting Too Big":¹⁴

"Most of the very large bank trust departments almost inevitably tend to have relatively similar investment criteria, such as a predilection for large growth issues and an aversion to cyclical and small concerns. If their philosophies, which are already widely followed by other managers, become the principal determinant of stock values, as now seems a distinct possibility, there could be serious economic dislocations, especially a flow of capital away from small, high-risk concerns—which foster entrepreneurship, innovation and competition—to entrenched industrial structures."

More pointedly, Mr. C. V. Woods (President of McCulloch Oil Company), Chairman of the Committee of Publicly Owned Companies, stated before the Senate Finance Committee that the critical problem facing the nation (in 1973) is "concentration of control in our securities markets" and continued:

"With all respect to the genius of the people who run our great banks and institutions and the young, longhair analysts who advise them, one of these days the pool they're running in a few religion stocks will start to leak—and the fantastic, overvalues that they've created will be washed away in a flood. Unfortunately, we'll all be the sufferers."

* * * * *

"The fact of the matter is that because most of the investable funds in this country are controlled by a few banks and other institutions which also do about 70 percent of the dollar volume of trading on the New York Stock Exchange, the stocks of the companies that we present are undervalued to the danger point. We can't go to the equity market to raise money for replacement of expansion of our facilities. When we can't avoid raising money we have to do it through debt.

Debt service has become and is increasingly a severe burden on our companies, threatening the financial soundness of many of them. Tanking the Standard and Poor's list of 425 industrial companies, long-term debt has trebled from 1962 to the end of 1971. Debt-equity ratio has risen 26 percent to a dangerous 41 percent, and it is probably higher now.

Further, corporate underwritings of equity issues has dwindled to a trickle. In the first quarter of 1973, underwritings are down 40 percent compared with the same period in 1972; and dollar value of corporate private placements is down 30 percent."

* * * * *

"Our companies are inviting targets for takeovers by foreign as well as domestic capital. Some of us, faced with the practical impossibility of raising new money, are looking around for mergers, with other companies. Some of us have been the target of tender offers made at a premium above the depressed market values—and we are great bargains at those prices."¹⁵

¹⁴ December, 1973 issue of the Institutional Investor, pp. 74-75.

¹⁵ Hearings on Financial Markets by Subcommittee on Financial Markets of the Senate Finance Committee (First Session, 93rd Congress) July 26, 1973, pp. 156-157.

The combination of these factors—that is the concentration of an enormous amount of investment funds invested in a relatively small number of issues—spell out the problem of the concentration of economic power. If bank activities in the securities industry continue unchecked this situation is compounded to an unhealthy degree.

(2) THE CONFLICTS OF INTEREST IN BANK AUTOMATIC STOCK INVESTMENT SERVICE

Banks in recent years have engaged in, or attempted to engage in, a variety of securities activities, including sponsorship of open-end investment companies, sponsorship of closed-end investment companies, automatic stock investment service, dividend reinvestment plans and sponsorship of REITs. The Supreme Court of the United States held that bank sponsorship of open-end investment companies (pooled funds for managing agency accounts) violates the Glass-Steagall Act¹⁶ and suits are pending challenging bank sponsorship on closed-end investment companies¹⁷ and bank operation of automatic stock investment services¹⁸ as violations of the Glass-Steagall Act. Bank automatic stock investment services illustrate both a clear intrusion into the securities business and basic conflicts of interest for banks.

Under bank automatic stock investment services (AIS) a purchaser selects one or more stocks, usually from a list of 25 (the 25 corporations having the largest capitalization on the Standard and Poor's 425 Industrial Index), and authorizes the bank to make regular monthly deductions from his checking account for the purchase of the stock or stocks designated.

Because the plans operate by deductions from checking accounts, each purchaser must be a checking account customer of the bank when the plan goes into effect. Advertising for the plans, however, has been aimed at the general public, rather than being limited to those who are already customers of the bank. Thus, ads have been carried in newspapers and magazines of general readership.

The monthly deductions of purchasers who have selected a particular stock are pooled. At least once a month the bank establishes a cutoff date and thereafter purchases whatever amount of stock the pooled funds will buy. The period of time between the cutoff date and completion of purchase by the bank is called the "Acquisition Interval" and is limited to thirty days.

For services provided by the plan, each purchaser pays his proportionate share of brokerage charges and, in addition, pays the bank a service charge. The price per share to each purchaser may not be the price at which any particular transaction is made. The plan provides that the price will be the "average price (including brokerage costs) paid by the Bank for all shares of that stock purchased by it under the Service during that Acquisition Interval." All shares acquired under the plan will be held in the name of the bank or its nominee, but the bank will deliver certificates for whole shares to any purchaser on request.

The New York Stock Exchange and the Investment Company Institute on September 24, 1974, filed suit against the Comptroller of the Currency in the U. S. District Court for the District of Columbia to secure a declaratory judgment, injunctive and other relief, primarily a declaration that bank operation of automatic investment services is unlawful under sections 16 and 21 of the Glass-Steagall Act. The Court on December 5, 1975, concluded that the Comptroller's interpretation of the Glass-Steagall Act (permitting banks to operate automatic investment services) was correct as a matter of law and granted a summary judgment for the defendant. The Exchange and the ICI have appealed that decision.

A bank's interest will always lie in utilizing funds of AIS participants for as long as possible. These funds are free money. The AIS purchasers' inter-

¹⁶ *Investment Company Institute, et al v. Camp*, 401 U.S. 617.

¹⁷ *Investment Company Institute v. Board of Governors of the Federal Reserve System, et al*. Civil action in the Federal District Court for the District of Columbia, dismissed on procedural grounds, 398 F. Supp. 725 (1975); appeal pending.

¹⁸ *New York Stock Exchange and Investment Company Institute v. Smith, Comptroller of the Currency*. Civil action 74-1405 in the Federal District Court for the District of Columbia, defendants' motion for summary judgment granted December 5 1975; appeal pending.

ests, on the other hand, may well lie in effecting the stock purchase as rapidly as possible, particularly if the price of their stock is rising.

A simple example may illustrate. If a bank has \$1 million of AIS purchasers' funds for investment, those funds might well earn \$10,000 a month in the commercial department. The AIS plan provides that a bank may purchase anytime during an acquisition interval of 30 days, and in this case it clearly would be in the bank's interest to use all of that time. By purchasing immediately, rather than 30 days later, the bank would forego \$10,000 in earnings—on the purchaser's money. They purchasers, on the other hand, might be buying a stock that is rising in price through the entire month.

If a bank is selling from its trust accounts the same stock that it is buying for AIS purchasers, how does it time the sell and buy orders? If both the AIS customers and the trust department are buying, how are orders timed? Substantial purchases for the trust department may raise the price for a subsequent purchase of the same stock for AIS participants.

The bulk of the orders from such programs would be concentrated in the same small group of issues which are favorites for large institutional investors, thus further concentrating investment in a few issues.

Further, the pooling of smaller orders into larger orders, tends to increase the dominance of the market by institutional investors.

Grandfathering Provisions

Section 301(b) (1) of S. 2721 would provide that any bank holding company may continue to engage in those activities in which it directly or through a subsidiary was lawfully engaged on November 1, 1975, except that this shall not permit the scope or size (in terms of volume of business) of those activities to expand to any significant degree. However, Section 301(b) (2) would provide that the Federal Reserve Board, after opportunity for hearing, may terminate the authority to continue any activity if the Board deems that such action is necessary to prevent any other consequences described as "adverse effects" under the amended Section 4(c) (8).

If an activity is prohibited, we see no logic in permitting a bank holding company or its affiliate which is already engaged in that activity to continue such prohibited activity. We suggest that prohibited activity be terminated within 5 years from the effective date of the amendments.

Uniform Application of Standards Governing Entry Into Bank Related Fields

Section 401 of S. 2721 would provide that no national bank shall directly or through a subsidiary engage in any activity which is found after the effective date of the Act to be an improper activity for bank holding companies under Section 4(c) (8) or an improper activity for the bank holding company of which such national bank is a subsidiary, except that this section shall not be interpreted as authorizing a national bank to engage in any activity prohibited to it under any other provision of law.

The Exchange believes that this provision is highly desirable to provide uniform application of the standards governing bank entry into non-bank areas, particularly to avoid banks seeking to escape the restrictions of the Bank Holding Company Act by obtaining authorization from a more permissive bank regulatory authority.

Conclusion

The New York Stock Exchange supports the adoption of sections 301(a) and 401 of S. 2721 to provide more restrictive and specific standards to be applied in determining whether bank holding companies and their subsidiaries may engage in non-banking activities, as a desirable step to curb further concentration of economic power and conflicts of interest in banks and bank holding companies and thereby to encourage effective competition. To minimize controversy in interpretation of the standards, it might be desirable to further amend the Bank Holding Company Act to specifically prohibit bank holding companies and their affiliates from operating an automatic stock purchase service or engaging in the general securities brokerage business.

The Exchange suggests that the grandfathering provision of section 301(b) be amended to require termination of any prohibited activity within 5 years from the effective date.

COMPETITION IN BANKING ACT OF 1976

FRIDAY, MARCH 5, 1976

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 10 a.m., pursuant to call, in room 5302, Dirksen Senate Office Building, Senator William Proxmire, chairman of the committee, presiding.

Present: Senators Proxmire, Sparkman, McIntyre, and Garn.

The CHAIRMAN. The committee will come to order.

This is our second hearing this morning. Today we begin our second day of hearings on S. 2721, the Competition in Banking Act of 1975. Yesterday we heard a number of witnesses in various segments of the insurance industry discuss how bank holding companies unfairly compete against them. Banking institutions market a valuable commodity in our society. They allocate credit to borrowers. This is a basic public interest function. At various times, if not all times, that commodity may be scarce. When banks venture outside their primary role which is to make loans to creditworthy borrowers and into the marketing of ordinary commercial services, a major distortion occurs. Purchasers of such commercial services tend to ingratiate themselves with the bank by buying the commercial services from them in the hope that their credit needs will be fulfilled. Banking institutions reinforce this psychological attitude and in some cases by suggesting and in other cases requiring the purchase of commercial services in order for the customer to obtain credit.

The result is a massive distortion of the competitive market. Services are no longer purchased on the basis of need and quality and this is bad business.

Today we will hear from a number of other industries in the matter of banks overstepping the proper bounds between finance and commerce. We will hear from spokesmen for the securities industry who I hope will shed light on the serious conflicts of interest which results when banks engage in commercial business. We will also hear from the automobile dealers, the travel agents, and the other industries.

The mere recitation of this laundry list of activities into which banks have penetrated is disturbing. One may ask the question, What in the world does the marketing of those kinds of services have to do with the accepting of the deposits or the making of loans? The straight answer is not much. Bank expansion in the recent past has been the result of go-go expansionist syndrome acquired by competitive laxity among the regulators who are established to protect the public interest, but now find the services of their constituency banks come first.

The result of the era we are passing through is distressing as we all continue to witness. Today we will hear more specific testimony on how bank expansion has or may affect competition in several commercial fields outside insurance. Our first witnesses will be Mr. Robert Augenblick on behalf of the Investment Company Institute, and Mr. Edward O'Brien of the Securities Industry Association.

I take it that Mr. O'Brien and Mr. Augenblick have statements and that you will introduce the other gentlemen who are with you this morning for the record.

STATEMENT OF EDWARD I. O'BRIEN, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION; ACCOMPANIED BY JAMES W. WALKER, JR., EXECUTIVE VICE PRESIDENT; AND JOHN M. LIFTIN, COUNSEL

Mr. O'BRIEN. Good morning, Senator.

Mr. Chairman, my name is Edward I. O'Brien and I'm president of the Securities Industry Association, a national trade association representing approximately 650 organizations responsible for over 90 percent of the securities brokerage and investment banking business of the nation. With me today are James W. Walker, Jr., executive vice president in charge of our Washington office, and our counsel, John M. Liftin of the law firm of Rogers & Wells.

Our membership is a cross section of the many different facets of the securities business and encompasses members of national securities exchanges and firms which are not members of such exchanges. The business of our members includes retail and institutional brokerage, over-the-counter market making, underwriting and other investment banking activities, and various exchange floor functions. Many of our members perform these services in municipal and government, as well as corporate, securities. Geographically, the firms which comprise our membership are located all across the Nation and provide services to investors of every size and type.

I am submitting a longer written statement, Mr. Chairman, and will then proceed with the oral statement.

The CHAIRMAN. Your longer statement is the 20-page statement?

Mr. O'BRIEN. Yes.

The CHAIRMAN. That will be printed in full in the record.

[Complete statement follows:]

STATEMENT OF SECURITIES INDUSTRIES ASSOCIATION

Mr. Chairman, my name is Edward I. O'Brien, and I am President of the Securities Industry Association, a national trade association representing approximately 650 organizations responsible for over 90% of the securities brokerage and investment banking business of the nation. With me today are James W. Walker, Jr., Executive Vice President in charge of our Washington office, and our counsel, John M. Liftin of the law firm of Rogers & Wells. Our membership is a cross section of the many different facets of the securities business and encompasses members of national securities exchanges and firms which are not members of such exchanges. The business of our members includes retail and institutional brokerage, over-the-counter market making, underwriting and other investment banking activities and various exchange floor functions. Many of our members perform these services in municipal and government, as well as corporate, securities. Geographically, the firms which

comprise our membership are located all across the nation and provide services to investors of every size and type.

We appreciate the opportunity to appear before you today to offer our comments on a piece of legislation that we believe is essential to the continued stability of the banking system and to the vitality of our economy, "The Competition in Banking Act of 1975." The provisions of this bill are responsive to many of our concerns about the increasing domination by commercial banks of the nation's financial resources.

For example, the bill would limit the further concentration of banking resources among the major commercial banks. Such a limitation is essential because those banks and their holding companies already wield an overwhelming degree of control, not only over bank resources, but also over other financial resources, such as trust assets. Their encroachment into the securities industry further exacerbates this concentration.

The bill also would limit the incursions of banks and their holding companies into "commerce"—i.e., into non-banking activities. This tendency to expand into other businesses not only increases the concentration of economic power in the major commercial banks, but also tends to produce other problems, such as misallocation of credit, unfair competition and conflicts of interest. Such problems have been particularly acute in the case of bank-sponsored securities activities.

Moreover, as the major banks have attempted to utilize their ready access to deposits in offering an ever-widening range of services, their capital structure in many cases has become seriously impaired. In recognition of this problem, the bill would require the Federal Reserve Board to supervise carefully the capital structure of bank holding companies and their subsidiaries. We believe such supervision is especially necessary to guard against liquidity problems associated with the long-term bank loans which are extended to many corporations as a substitute for equity capital.

In sum, we strongly endorse the underlying principles and basic approach of this bill; however, we would like to suggest several minor amendments. First, to avoid the "competition in laxity" at which section 401 of the bill is aimed, we suggest that the Board be given power to limit the non-bank activities not only of national banks, which the present language would give it, but also of all member banks of the Federal Reserve System or, even more desirable, of all federally insured banks. Secondly, to assure that banks and bank holding companies are prohibited from engaging in those activities enumerated in section 2(c) as prime examples of areas which are not directly related to banking, we believe that section 01 should be amended expressly to proscribe such activities to banks. Also, although it may be unambiguous, we suggest that the bill's legislative history make clear that the "concentration of financial resources" standard set forth in section 301, as one of the factors to be considered in determining permissible non-banking activities, includes those resources owned or controlled by mutual funds, insurance companies, securities underwriters and other financial intermediaries as well as by banks. Finally, we believe that the mandate to the Fed in section 501 to supervise the adequacy of bank holding company capitalization should be amended to require that that supervision take account of the illiquidity associated with excessive long-term loans and to extend such supervision to all members banks (or all insured banks), again to avoid competition in laxity. The need for these relatively minor amendments to a bill which clearly is a long overdue step toward restoring better balance and more efficiency to our financial markets is discussed more fully below.

SECURITIES ACTIVITIES OF THE MAJOR COMMERCIAL BANKS

We believe bank expansion into the securities business provides an excellent example of the abuses toward which this legislation is directed. As the trade association for the securities industry, we, through our members, are particularly aware of the many securities in which banks are engaged. The securities activities of banks may be divided into three general areas: (1) investment advisory services, (2) brokerage related services, and (3) investment banking services.

A. Investment Advisory Services

Apart from their own assets, banks are responsible for the management of more funds than any other type of financial institution.¹ In their fiduciary capacity, banks manage the assets of pension and other employee benefits plans and of trusts and estates of individuals. In their agency capacity, they manage the portfolios of a variety of individual and corporate customers. In addition, banks serve as investment advisers to both open-end and closed-end investment companies and also act as investment advisers to REITs, which they sponsor in many cases.

B. Brokerage Related Services

In recent years, many banks have begun to offer several brokerage related services to their customers. One of the more common of these is the automatic investment service (AIS). Through AIS plans, banks offer customers the opportunity to have a specified amount deducted automatically each month from their checking accounts and invested by the banks in the common stock of one or more issuers included on a list supplied by the bank. The list typically includes the twenty-five largest corporations in the Standard and Poor's 425 Industrial Index, based on the market value of the corporations' outstanding common stock. The bank pools the monthly deductions from the account of each participating customer and orders a broker to execute transactions for the pooled accounts. Each AIS customer receives a monthly statement indicating, among other things, the number of shares purchased and their price.

Banks also offer dividend reinvestment plans under which investors may have the dividends they receive from a participating corporation automatically reinvested in the securities of that corporation. Through these plans, shareholders of a participating corporation may request that their dividends be paid directly to a bank, which pools the dividends received and purchases additional shares of the corporation's stock in the open market.

Besides pooling funds and acting as a conduit between brokers and customers, some banks perform a more traditional type of brokerage by executing agency transactions for their trust and other managed accounts, either through a registered broker, in the case of listed securities, or directly in the over-the-counter market.

C. Investment Banking Services

The investment banking activities of the major commercial banks generally take two forms: the rendering of financial advice to corporations and the finding or furnishing (or both) of funds for the long-term capital needs of corporations. Financial counseling may be provided for a fee either on a long-term basis or for specific projects (e.g., the financing of a new plant) and generally comprehends the customer's total need for financing, ranging from short-term borrowings to permanent capital. Banks also furnish financial advice in connection with corporate reorganizations, including mergers and acquisitions, and sometimes perform appraisal services in connection with such transactions.

Banks also serve directly as a source of long-term funds, either through their own lending facilities or by arranging private placements of securities with other lenders. Frequently, loans are made through syndicates of banks, which contain from a handful to a substantial number of domestic, and sometimes foreign, banks.

In addition to providing long-term funds themselves, banks have become quite active in arranging, for a fee, private placements of securities of all types, from long-term bonds to equities, with a variety of institutional lenders. In some instances, banks participate in private placements they have arranged by purchasing for portfolios under their management a portion of the securities to be sold, and on occasion a bank will assemble for a customer a financing package consisting of a medium-term loan from the bank itself, together with a private placement to provide the ultimate long-term financing.

¹The Treasury Department has estimated that commercial banks manage approximately \$400 billion in trust assets alone. *Public Policy Aspects of Bank Securities Activities, An Issues Paper*, Department of the Treasury, November, 1975, p. 7.

RELATIONSHIP OF BANK SECURITIES ACTIVITIES TO CONCERNS REFLECTED
IN PROPOSED LEGISLATION

The provision of securities services by the major commercial banks raises concerns among our members similar to those to which the bill is addressed and, as discussed below, suggests the need for minor amendments to assure that the bill will achieve its stated objectives.

A. "Adverse Effects" of Bank Securities Activities

The proposed amendment to section 4(c) (8) of the Bank Holding Company Act of 1956 contained in section 301(a) of the bill would require the Fed to consider certain specified "adverse effects" in determining whether an activity it finds to be closely and directly related to banking is to be a permissible activity for bank holding companies. Bank participation in the securities business can result in a number of such adverse effects, including unfair competition, conflicts of interest and undue concentration of financial resources, as well as the misallocation of credit.

1. Unfair Competition.—Under existing law, banks enjoy numerous advantages not available to commercial entities such as the members of securities industry. These advantages give banks an almost insurmountable, and wholly unfair, edge in competing with our members.

The principal such advantage possessed by banks is their unique ability to accept deposits. This enables them to obtain funds at comparatively low cost—in some cases at no cost—without the expensive and time-consuming disclosure process which commercial entities must follow. Banks also have primary and direct access to a reliable and extensive source of funds through their ability to borrow from the Federal Reserve System at low interest rates, even when they are suffering from financial difficulties which would prevent a non-bank entity from obtaining credit. Moreover, banks possess substantial tax advantages, such as their ability to deduct the interest cost of carrying or purchasing tax-exempt securities and their ability to set up reserves for losses.

Banks also have unfair advantages over members of the securities industry in the operation and promotion of their securities services. For example, bank borrowers and depositors provide a convenient and favorable market for the promotion of any additional services a bank may choose to offer. In addition, the sheer size of the major commercial banks and the diversity of their financial and managerial resources enable them to utilize economies of scale unavailable to other competitors in performing securities services.

Furthermore, banks are in a position to use the economic leverage inherent in their ability to extend short-term credit to establish explicit or implied tying arrangements—i.e., according preferential lending treatment to users of their securities services.² Even if a bank has no explicit policy of so using this economic power, the probable expectation of customers or prospective customers that such a connection exists suggests that fair competition may not be possible when a bank offers services in competition with non-bank entities.

These competitive advantages make it relatively apparent that banks would dominate the securities industry were they to compete directly in offering securities services.

2. Conflicts of Interest.—A bank's performance of various securities services may result in conflicts of interest adverse to: (1) its trust customers and other managed accounts, (2) its commercial customers, and (3) users of its securities services.

One of the more egregious conflicts between a bank's interest in a securities service it is providing and its duties to the accounts it is responsible for managing exists in any case where a bank trust department causes one of such accounts to purchase securities that are being placed privately by the bank for a corporate client or distributed by the bank as underwriter, in the

² The Conference Committee that reported the Bank Holding Company Act Amendments of 1970 specifically noted the possibility of this occurring: "Such tie-ins may result from actual coercion by a seller or from a customer's realization that he stands a better chance of securing a scarce and important commodity (such as credit) by 'volunteering' to accept other products or services rather than seeking them in the competitive market place. In either case, competition is adversely affected, as customers no longer purchase a product of service on its own economic merit." H.R. Rep. No. 1747, 91st Cong., 2nd Sess. 18 (1970).

case of municipal bonds. Even where restrictions in private trust agreements or legal proscriptions prevent this conflict from occurring directly, two or more banks may have a tacit understanding that the trust department of each will participate in the private placements or underwritings of the other. Further, if a private placement proves a disappointment, the bank's trust department may be tempted to cause accounts that it manages to make investments in, or to lend money to, a corporation for which the bank has affected the placement in an attempt to assuage the dissatisfaction of the placement participants.

The charges reported in the recent Microdot-Irving Trust episode is one of the more dramatic examples of potential conflict between a bank's securities services and its commercial customers. In that case, it was alleged that Irving Trust used its confidential knowledge of the financial condition of its credit customer, Microdot, in the course of providing advisory services to General Cable—also a credit customer—in its bid to capture control of Microdot through a tender offer. Although the facts must await adjudication of that dispute, it is obvious that, in the course of providing financial advisory services, there are many opportunities for a bank to make improper use of confidential financial information obtained from its credit customers.

In providing an AIS plan or dividend reinvestment plan to customers, a bank is in a position to delay placing orders for its pooled accounts in order to enjoy the use of the funds without interest, and on some occasions such a delay may result in a less favorable execution for such accounts. Similarly, the bank trust department is in a position to take advantage of its knowledge of when an order for an AIS or dividend reinvestment plan will be executed in placing orders for accounts that it manages.

A bank also may have a conflict between the interests of its financial advisory customers in objective advice and its own business interests in extending loans. For example, when a corporation consults a bank for financial advice, the bank may be tempted to advise the corporation to meet at least some of its capital needs through bank borrowings, even where the terms of such borrowings may not be as favorable as those obtainable in the public market.

3. Concentration of Financial Resources.—As the Chairman suggested in his remarks introducing this bill, its main purpose is to prevent the concentration of economic power in the major commercial banks and their holding companies. By way of example, those remarks cite the concentration of bank assets in the major commercial banks. The Association believes that even more serious than this concentration of bank resources is the concentration of financial resources in general that may result from the continued offering of securities services by such banks.

There are six principal kinds of institutions in the American economy that act as financial intermediaries, channelling idle funds and savings to those with commercial and investment needs for such funds: (1) insurance companies; (2) thrift institutions; (3) commercial banks; (4) trust companies (or trust departments of commercial banks); (5) mutual funds; and (6) brokerage dealers. Commercial banks already dominate the two largest and fastest growing of these, categories (3) and (4).

The trust departments of commercial banks manage over \$400 billion in assets of personal trusts, estates and employee benefit and pension plans.³ Besides these enormous trust assets, commercial banks have available for lending or other investment approximately \$900 billion of their own assets. Thus, commercial banks control over \$1,300 billion of assets. This concentration of control over financial assets is in itself shocking, but what is far more worrisome, in our opinion, is the fact that control of over 70 percent of the trust assets is held by less than 2 percent of the commercial banks and, as the Chairman mentioned in his remarks introducing the bill, that almost 40 percent of the assets of commercial banks is held by less than 2 percent of those banks. These figures suggest an overwhelming concentration of economic power in the hands of the very few largest banks.

³ The next largest category of asset management institution, insurance companies, manage only an estimated \$300 billion in assets.

If the Financial Institutions Act of 1975 (S. 1267)—repealing both interest rate ceilings on time deposits and restrictions on paying interest on demand deposits—becomes law, commercial banks eventually will absorb most of the deposits held by thrift institutions and dominate their functions as well.

The same large money-center banks also happen to be those most active in offering securities services in competition with broker-dealers. Their sheer size, in relation to the securities industry, is illustrated by the fact that the shareholders' equity of Citicorp, Inc., the parent holding company of First National City Bank, was \$2.074 billion at the end of 1974, almost as large as the \$2.346 billion which was the aggregate shareholders' equity and proprietors' capital at that time of all members of the New York Stock Exchange. Because of their disproportionate size, as well as the other decided competitive advantages mentioned above, it seems probable that banks also will come to dominate the securities industry, giving them control of four of the above six categories. If banks succeed in dominating the securities industry, virtually every source of investment capital—save insurance companies and mutual funds—would be controlled by these few giant banks, a situation which presently prevails in Europe.

4. *Bank Expansion Into Commerce.*—In his remarks introducing this bill, the Chairman discussed the misallocation of credit resources that results from incursions by banks into non-banking fields. Whenever a bank has a financial interest in a commercial enterprise, it is possible that credit determinations with respect to that enterprise will not be made solely on the basis of disinterested banking judgment. The experiences of the members of the Association would suggest that banking judgment is equally subject to distortion when banks participate in the securities industry.

Such bank involvement raises many conflicts between a bank's interest in its various securities services and its duty to make prudent and disinterested loans solely on the basis of banking and credit judgments. For example, a bank may extend credit to a corporation as an inducement for that corporation to patronize financial advisory services of the bank. Also, a bank may be tempted to make loans to a corporation in which some of the bank's AIS customers have invested in order to prevent that corporation's financial difficulties from reflecting adversely on the bank or to extend credit to a corporation for which it effected a private placement of securities to maintain its "credibility" with those who participated in the private placement. Recent history provides a vivid example of the potentially serious consequences of the conflict between a bank's interest in furnishing investment advisory services and sound banking practices: the substantial loans which many commercial banks have extended to (or purchased from) the REITs sponsored and managed by them or one of their subsidiaries appear in many cases to have been effected in less than a prudent and disinterested manner.

Apart from producing a distorted allocation of credit, the conflicts between a bank's interest in its securities activities and its duty to observe sound banking principles may also seriously jeopardize the stability of the banking system. For example, many of the banks which recently have been revealed as "problem banks" possess loan portfolios laden with loans to their REITs.

5. *Suggested Amendments.*—Because the many potential abuses which may be associated with the securities activities of banks are reflected in the list of "adverse impacts" in section 301(a) of the bill, we strongly endorse the scope of that list. However, the Association would suggest several amendments to strengthen and clarify that section.

To prevent the major commercial banks from gaining further control over sources of investment capital, we suggest that the reference in section 301(a) to "concentration of . . . financial resources" be clarified. Thus, either through language in the bill or in its legislative history, it should be made clear that no bank may engage in non-banking activities—even if directly related to banking—if such involvement would cause any further concentration of resources among any type of financial intermediary, such as securities underwriters, insurance companies and mutual funds. The Association believes that such a clarification is necessary to assure that the major commercial banks do not further their control over our nation's capital resources.

Furthermore, to preclude most of the potential abuses discussed above, we strongly support the approach taken by section 301(a) of the bill in placing

greater limitations on non-banking activities. However, we suggest a minor amendment to that section. We believe banks should be expressly prohibited, in a new clause of section 301(a) (which amends section 4(c)(8) of the Bank Holding Company Act of 1956), from engaging in those activities enumerated in section 2(c). The new clause, to be inserted in subparagraph (B), would read as follows:

"() the term 'closely and directly related to banking or managing or controlling banks' does not include (1) offering insurance agency and underwriting services, (2) offering leasing, accounting, travel or courier services, (3) offering management and data processing services, or (4) soliciting purchases or sales of securities (except investment securities to the extent permitted to national banking associations by the provisions of section 24 of this title),"⁴

B. Competition in Laxity

Both past and recent history bear out the proposition that when banks are able to choose among several regulators a "competition in laxity" may occur, and banks may switch charters in order to avoid restrictive regulatory policies of a particular agency. The result often can be the frustration of critical national policy objectives. In the second and third decades of the twentieth century, so many state chartered banks had securities affiliates that the Comptroller at first ignored his duty to prevent national banks from engaging in such activities and, then, successfully lobbied Congress to permit them to engage in those activities.

The end of that competition among regulators was prompted by the failure of many banks in 1933 due to the losses incurred by their securities affiliates. More recent history has seen banks converting to one-bank holding companies during the 1960's in an attempt to employ their competitive advantages in areas outside of banking. Also, as the Chairman mentioned in his remarks, bank holding companies which have been denied permission to engage in certain activities by the Federal Reserve Board have succeeded in obtaining approval by the Comptroller of the Currency for the very same activities.

Since most of the securities activities of banks are provided by banks themselves, rather than by subsidiaries of bank holding companies, those activities are subject to the more permissive regulation of the Comptroller of the Currency and of various state banking authorities, rather than the stringent controls imposed by the Fed. For that reason, the Association strongly endorses the intent, expressed in section 401, of having the Federal Reserve Board determine permissible non-banking activities of national banks. However, we would urge that a uniform and coherent national policy respecting competition in the banking industry—which this bill seeks to enact into law—requires that competing state and national banks be treated equally in this critical regard. In the absence of such uniformity, attainment of national policy objectives may be frustrated. Thus, we believe section 401 should be extended to apply to all members banks, if not to all insured banks.

D. Undercapitalization of Banks

Expansion of banks into non-banking areas may seriously compound the problem of inadequate bank capital. To the extent banks devote their capital resources to investment in other activities, they are deprived of the use of those funds to support their lending activities. In addition, the tendency over the past decade has been for banks steadily to increase the maturity of the loans they extend. Such loans may be said to have equity attributes in that the terms of the accompanying loan agreements may give the lender virtual control over the corporate borrower and in that the repayment of the loans may depend more on the long run success of the borrowing enterprise than on normal considerations of solvency.

Such long term loans may affect bank liquidity adversely in two respects. The probability of such loans being repaid at maturity generally is somewhat lower than with short-term borrowings. Moreover, because of the extended maturity of these loans, banks may lose some of their flexibility to adjust to unanticipated declines in their deposits, many of which are subject to withdrawal on demand or short notice.

⁴ We assume that the phrase "marketing of securities" in section 2(c)(iv) is intended to refer to the solicitation of purchases or sales of securities.

To preclude such risks to bank liquidity, we suggest two minor amendments to section 501. First, that section should be revised specifically to require bank regulators to consider, in determining the adequacy of a bank's capitalization, the relationship between long term loans and other illiquid assets on the one hand and long term sources of funds, such as time deposits and shareholders' equity, on the other. Secondly, to avoid the problem of competition in laxity discussed above, we suggest that the provisions of section 501 be made applicable to all member banks or all insured banks.

CONCLUSION

We strongly endorse the trust of this proposed legislation and sympathize the many concerns to which the bill is addressed. Indeed, the concentration of economic power in the major commercial banks poses a serious threat which calls for legislative action. Their control over financial resources, if not our entire economy, suggests the need for strict limitations on both their size and their activities. We believe that this legislation, modified in accordance with our suggestions, will go a long way toward solving the problem as we perceive it.

The Association is working on a comprehensive study of the securities activities of banks. At the conclusion of that study we intend to transmit our findings to the Committee and respectfully request that they be included in the record. We appreciate this opportunity to offer our comments and suggestions on this important piece of legislation and will be happy to try to respond to any questions.

Mr. O'BRIEN. We very much appreciate the opportunity to appear before you today to offer our comments on a piece of legislation that we believe is essential to the continued stability of the banking system and to the vitality of our economy, "The Competition in Banking Act of 1975." Although we hardly claim to be experts on the subject of bank reform, the provisions of this bill are responsive to many of our concerns about the increasing domination by commercial banks of the Nation's financial resources.

At the outset, may I say it's the basic policy of the SIA to support steps which will preserve a strong banking system and to build and to hold public confidence along with a strong securities industry, as well as fair competition between the two. I would also like briefly to take this opportunity to compliment the chairman and the members of the committee and the staff for the thoroughness with which they have approached this problem in terms of the legislation.

As we see it, this bill would limit the further concentration of banking resources among the major commercial banks. Such a limitation is essential because those banks and their holding companies already wield an overwhelming degree of control, not only over bank resources, but also over other financial resources, such as trust assets. Their encroachment into the securities industry further exacerbates this concentration.

The bill also would limit the incursions of banks and their holding companies into commerce—that is, into nonbanking activities. This tendency to expand into other businesses not only increases the concentration of economic power in the major commercial banks, but also tends to produce other problems, such as the misallocation of credit, conflicts of interest and unfair competition. Such problems have been particularly acute in the case of bank-sponsored securities activities.

Moreover, as the major banks have attempted to utilize their ready access to deposits in offering an ever-widening range of services, their capital structure in many cases has become seriously impaired. In

recognition of this problem, the bill would require the Federal Reserve Board to supervise carefully the capital structure of bank holding companies and their subsidiaries. We believe such supervision is especially necessary to guard against liquidity problems associated with the long-term bank loans which are extended to many corporations as a substitute for equity capital.

In sum, we strongly endorse the underlying principles and basic approach of this bill; however, because of the many securities services in which banks are engaged, which are described in the somewhat more detailed written statement we have submitted for the record, we believe several minor amendments to the bill are desirable.

First, we would suggest modifications in section 301(a) of the bill. The proposed amendment to section 4(c)(8) of the Bank Holding Company Act of 1956 contained in that section would require the Fed to consider certain specified adverse effects in determining whether an activity it finds to be closely and directly related to banking is to be a permissible activity for bank holding companies. Bank participation in the securities business can result in a number of such adverse effects, including undue concentration of financial resources, unfair competition and conflicts of interest, as well as the misallocation of credit.

We are particularly concerned about the undue concentration of financial resources generally, a problem that would appear to be even more serious than the concentration of bank resources, the prevention of which is a major purpose of this bill. Financial resources are provided by six principal kinds of institutions in the American economy that act as financial intermediaries, channeling idle funds and savings to those with commercial and investment needs for such funds: (1) insurance companies; (2) thrift institutions; (3) commercial banks; (4) trust companies or trust departments of commercial banks; (5) mutual funds; and (6) broker-dealers. Commercial banks already dominate the two largest and fastest growing of these categories, commercial banks and trust companies. Between their own funds and trust assets managed by them, commercial banks control over \$1,300 billion of assets. This concentration of control over financial assets is in itself shocking, but far more worrisome is the fact that those assets are concentrated in the hands of the very few largest banks.

If The Financial Institutions Act of 1975—repealing both interest rate ceilings on time deposits and restrictions on paying interest on demand deposits—becomes law, commercial banks eventually may absorb most of the deposits held by thrift institutions and dominate their functions as well. Furthermore, the same large-money-center banks also happen to be those most active in offering securities services in competition with broker-dealers. Because of the disproportionate size of banks, as well as their other decided competitive advantages, it seems probable that banks also will come to dominate the securities industry, thereby giving a few giant banks control of virtually every source of investment capital—save insurance companies and mutual funds—a situation similar to that which prevails in Europe which I have had experience with.

To prevent this from occurring, we suggest that the reference in section 301(a) to "concentration of . . . financial resources" be clari-

fied, either through language in the bill or in its legislative history, to make clear that no bank may engage in nonbanking activities—even those directly related to banking—if such involvement would cause any further concentration of resources among any type of financial intermediary, such as securities underwriters, insurance companies, and mutual funds.

Aside from the problem of concentration, the provision of securities services by banks raises concerns about conflicts of interest, unfair competition and the misallocation of credit. Our concerns in these areas are more thoroughly discussed in our written statement. We believe that they are typical of the problems that arise when banks become involved in any area of commerce.

To prevent these problems, we strongly support the approach taken by section 301(a) of the bill in placing greater limitations on nonbanking activities. However, we suggest a second amendment to section 301(a). In a new clause to that section, banks should be expressly prohibited from engaging in those activities enumerated in section 2(c). Furthermore, the reference in section 2(c)(iv) to the marketing of securities should be spelled out in the new clause so as clearly to include the solicitation of the purchase or sale of securities. The specific language we propose is set forth in our written statement.

We would also suggest an amendment to section 401 of the bill. Both past and recent history bear out the proposition that when banks are able to choose among several regulators a competition in laxity may result, and banks may switch charters or otherwise shop regulators in order to gain more flexibility to expand their activities. For example, banks converted to one-bank holding companies during the 1960's in an attempt to employ their competitive advantages in areas outside of banking.

The association strongly endorses the bill's attempt to deal with this problem, in section 401, by authorizing the Federal Reserve Board to determine permissible nonbanking activities of national banks. We would urge, however, that a uniform and coherent national policy respecting competition in the banking industry—which this bill seeks to enact into law—requires that competing State and national banks be treated equally in this critical regard. In the absence of such uniformity, attainment of national policy objectives may be frustrated. Thus, we believe section 401 should be extended to apply to all member banks, if not to all federally insured banks.

Because expansion of banks into nonbanking areas may seriously compound the problem of inadequate bank capital, we also would suggest certain modifications in section 501 of the bill. The tendency over the past decade has been for banks steadily to increase the maturity of the loans they extend. Such long-term loans may affect bank liquidity adversely in two respects. The probability of such loans being repaid at maturity generally is somewhat lower than with short-term borrowings. Moreover, because of the extended maturity of these loans, banks may lose some of their flexibility to adjust to unanticipated declines in their deposits, many of which are subject to withdrawal on demand or short notice.

To preclude such risks to bank liquidity, we suggest two minor amendments to section 501. First, that section should be revised specifically to require bank regulators to consider, in determining the adequacy of a bank's capitalization, the relationship between long-term loans and other illiquid assets on the one hand and long-term sources of funds, such as time deposits and shareholders' equity, on the other. Second, to avoid the problem of competition in laxity discussed above, we suggest that the provisions of section 501 be made applicable to all member banks, or to all insured banks.

To summarize, Mr. Chairman, we strongly endorse the thrust of thus proposed legislation and sympathize with the many concerns to which the bill is addressed. Indeed, the concentration of economic power in the major commercial banks poses a serious threat which calls for legislative action. Their control over financial resources, if not our entire economy, suggests the need for strict limitations on both their size and their activities. We believe that this legislation, modified in accordance with our suggestions, will go a long way toward solving the problem as we perceive it.

The association is working on a comprehensive study of the securities activities of banks. At the conclusion of that study we intend to transmit our findings to the committee and respectfully request that they be included in the record. We appreciate this opportunity to offer our comments and suggestions on this important piece of legislation and will be happy to try to respond to any questions.

The CHAIRMAN. Thank you, Mr. O'Brien.

STATEMENT OF ROBERT L. AUGENBLICK, PRESIDENT, INVESTMENT COMPANY INSTITUTE; ACCOMPANIED BY RAMSAY POTTS, COUNSEL

Mr. AUGENBLICK. My name is Robert L. Augenblick. I am president of the Investment Company Institute and appear today on its behalf. With me is Ramsay Potts, outside counsel for the institute.

I propose this morning to summarize briefly the major points in our longer written statement and I do ask that the longer written statement be made a part of the record.

The CHAIRMAN. Yes; without objection, that will be done.

Mr. AUGENBLICK. The membership of the institute consists of 381 mutual funds, their investment advisers and principal underwriters. Our mutual fund members have over 8 million shareholders and assets of about \$46 billion, representing about 93 percent of the assets of all U.S. mutual funds.

Our testimony this morning is directed primarily to the desirability of section 301(a) of S. 2721 which tightens up both the existing closely related and public benefits tests with respect to nonbanking activities made permissible to a bank holding company component by section 4(c) (8) of the Bank Holding Company Act, and also to the desirability of section 401 of the bill which provides that an activity found by the Federal Reserve Board to be improper for a bank holding company is improper for a national bank and further explicitly

denies a national bank the right to engage in any activity prohibited to it under any other provision of law.

We support section 301(a) and section 401 of the bill. The focus of our testimony is on the increasing activities of banks in the securities business.

At the outset we wish to refer to what should be obvious. Banking interests should not be permitted to do indirectly what they are forbidden to do directly. The Bank Holding Company Act was never intended and cannot be used as an excuse to permit banking interests to avoid prohibitions elsewhere contained in the law—such as the provisions of the Glass-Steagall Act of 1933 which divorced the banking business from most aspects of the securities business.

The expanded activity by banks in the securities industry raises two fundamental questions:

First: Are the reasons that gave rise to the Glass-Steagall Act still valid today, or should the Glass-Steagall Act be amended so as to make it clear that banks may or may not engage in some or all of these securities activities?

Second: Is it in the public interest to sanction the increased concentration of economic power in banks by permitting them to enter the securities business and would this create unfair competition?

Among the securities activities which the banks are engaging in, have tried to engage in, or would like to engage in, are the following:

(1) Bank sponsorship and operation of open-end investment companies—mutual funds.

This involves the creation and merchandising by banks of pooled funds for managing agency accounts—found by the courts to be the functional equivalent of mutual funds. In a suit instituted by the Investment Company Institute against the Comptroller of the Currency, this activity was held by the Supreme Court of the United States in 1971 to violate the Glass-Steagall Act—*Investment Company Institute, et al. v. Camp*, 401 U.S. 617. Nevertheless, the American Bankers Association has announced its intention to seek legislation to overturn the *Camp* case and the Comptroller of the Currency has announced his support for permitting banks to enter the mutual fund business.

(2) Bank sponsorship of closed-end investment companies.

In the last few years, banks have created and sponsored closed-end investment companies having hundreds of millions of dollars. This activity is presently being challenged in a suit brought in the Federal District Court for the District of Columbia by the Investment Company Institute against the Board of Governors of the Federal Reserve System—*Investment Company Institute v. Board of Governors of the Federal Reserve System, et al.*, Civil Action No. 74-697, July 30, 1975. The suit, which seeks a judicial declaration that the regulation of the Federal Reserve Board permitting such sponsorship violates the Glass-Steagall Act and the Bank Holding Company Act, has been dismissed on procedural grounds and an appeal is pending.

(3) Bank automatic stock investment plans.

Banks are aggressively marketing these plans under which a depositor directs the bank to withdraw monthly an amount—usually a minimum of \$20 and a maximum of \$500 per company—from his checking account to purchase shares of one or more of the 25 companies with the largest capitalization appearing in the Standard & Poor's 425 Industrial Index. The bank receives a fee for its service. The New York Stock Exchange and the Investment Company Institute have jointly brought an action in the Federal District Court for the District of Columbia against the Comptroller of the Currency seeking a judicial declaration that the Comptroller's regulation permitting such activity violates the Glass-Steagall Act. Summary judgment was awarded to the Comptroller and an appeal is pending.

(4) Dividend reinvestment plans.

Banks are aggressively merchandising these plans under which the banks for a fee will reinvest dividends of a particular corporation in the stock of the corporation and often will permit the stockholder to add up to an additional \$1,000 monthly for reinvestment by the banks in such stock.

(5) Sponsors of reits.

Banks have recently sustained huge losses in connection with real estate investment trusts because of the banks' involvement as sponsors and leaders.

A word about the Glass-Steagall Act. After the congressional study as to reasons for the stock market debacle of 1929 and ensuing depression years, Congress in 1933 passed the Glass-Steagall Act which was in large part designed to divorce the banking business from the general securities business.

In considering the issue of Glass-Steagall, we take as a focal point the hazards to the public which the Supreme Court of the United States found to exist in 1971, only 5 years ago, if a bank were permitted to sponsor and merchandise its own mutual fund—hazards which permeate the other bank securities activities in varying degrees of intensity.

The potential dangers to the public which result from these activities are highlighted in the Supreme Court's decision in the *Camp* case referred to above. In finding that "the potential hazards and abuses that flow from a bank's entry into the mutual fund business are the same basic hazards and abuses that Congress intended to eliminate almost forty years ago," the court pointed to specific hazards as follows:

The bank's stake in the investment fund might distort its credit decisions or lead to unsound loans to the companies in which the fund had invested. The bank might exploit its confidential relationship with its commercial creditors for the benefit of the fund. The bank might make loans to facilitate the purchase of interests in the fund. If the fund investment should turn out badly there would be a danger that the bank would lose the good will of those customers who had invested in the fund.

To these might be added the temptation to invest the fund's assets in and possibly to shore up companies having outstanding loans with the bank.

Let me turn now to undue concentration of economic power in banks and the issue of unfair competition. Commercial banks have acquired huge assets which carry with them a powerful capacity to dominate our Nation's business and to influence our securities markets. It is a truism that banks are far and away the largest of private financial institutions.

One of the arguments that banks make in favor of being permitted to compete in the securities business is that they can do it better and cheaper. Even if this were true—which is doubtful—the justification for permitting banks to enter the securities business must also be measured in terms of the fairness or unfairness of the competition which would be represented by bank entry into the business. Moreover, there is no lack of competition in the securities industry today. For example, there are over 600 mutual funds being offered today to the public.

It seems clear that, apart from other impacts on the U.S. economy, if banks are permitted to compete in the securities business their concentration of economic power will produce unfair competition favoring the banks as against their competitors.

Some of the reasons for this conclusion are as follows: First: Banks would have a tremendous competitive advantage because of their built-in customers and their leverage over financial decisions made by these customers. Every day thousands of customers stream across the threshold of banks for the purpose of making deposits, making loans, paying off loans, and taking advantage of many other banking services. The financial health, even the financial existence of many of these customers depends upon a satisfactory relationship with the bank. Under these circumstances, pressure from a bank does not have to be very direct to enable it to capture all of a customer's financial business.

Two: Not only are the customers physically present in the bank, but banks are permitted to, and do, advertise their services in a much more aggressive and liberal fashion than is permitted to financial institutions such as mutual funds that are subject to regulation by the Securities and Exchange Commission and State securities administrators.

The merchandising of securities services by institutions other than banks is closely regulated under Federal and State law. Banks, however, are generally exempt from the provisions of the Federal securities laws and probably from most State securities laws.

Three: The trust department of a bank has access to inside information not available to competitors in the investment business. Although the banks like to talk of a "Chinese Wall" between the trust department and the commercial department, there is far too much danger that the wall will be perforated—that the trust department, in choosing to make or change investments for its customers, will have the advantage of inside knowledge possessed by the commercial department concerning companies that are customers of the commercial department.

Four: Many banks hold themselves out as investment advisers and thousands of people go to them for impartial investment advice. If a bank is permitted to operate and make a profit out of its own mutual fund, is it likely that the bank will recommend a competitive mutual fund to a customer seeking impartial investment advice?

In conclusion, we emphasize that it is essential to preserve the integrity, and not to permit the dilution, of the Glass-Steagall Act. Moreover, the strengthening of the public benefits test, as proposed in the bill, is a distinct improvement on the standards presently applicable to the legitimacy of nonbanking activities within a bank holding company structure.

We also suggest that it might be well for Congress to give some guidance to the Federal Reserve Board to assist it in determining what is or is not so "closely and directly" related to banking as to be "a proper and necessary" incident thereto. There has been too much costly litigation already with respect to the nonlegitimacy of many banking activities. We think Congress should make it plain that, among other activities, the sponsorship, management, and promotion by banks of their own mutual funds and of automatic stock investment plans do not meet the bill's criteria for legitimate activity by a component in a bank holding company complex.

For the foregoing reasons, we support sections 301(a) and section 401 of S. 2721, and we do appreciate this opportunity to testify on this matter.

[Complete statement of Mr. Augenblick follows:]

STATEMENT OF ROBERT L. AUGENBLICK, ON BEHALF OF THE
INVESTMENT COMPANY INSTITUTE

My name is Robert L. Augenblick. I am President of the Investment Company Institute, 1775 K Street, N. W., Washington, D. C., and appear today on its behalf. With me is David Silver, the Institute's Senior Vice President and General Counsel.

The membership of the Institute consists of 381 mutual funds, their investment advisers and principal underwriters. Our mutual fund members have over 8 million shareholders and assets of approximately \$46 billion, representing about 93% of the assets of all U.S. mutual funds.

Our testimony this morning is primarily directed to the desirability of Section 301(a) of S. 2721 which tightens up both the existing "closely related" and "public benefits" tests with respect to non-banking activities made permissible to a bank holding company component by Section 4(c)(8) of the Bank Holding Company Act (the "Act"), and also to the desirability of Section 401 of the bill which provides that an activity found by the Federal Reserve Board to be improper for a bank holding company is improper for a national bank and further explicitly denies a national bank the right to engage in any activity prohibited to it under any other provision of law.

We support Section 301(a) and Section 401 of the bill.

Present Section 4(c)(8) of the Act enables a bank holding company to acquire a company the activities of which are determined by the Federal Reserve Board to be "so closely" related to banking or managing or controlling banks as to be a "proper" incident thereto. We endorse the provisions of Section 301(a) of the bill which would require that the non-banking activities be not only "closely" but also "directly" related to banking so as to be not only a "proper" but also a "necessary" incident. The additional public benefits test is also tightened by the bill in a number of ways that, we believe, place desirable restrictions on non-banking activities.

In recent years banks, largely through the device of bank holding company complexes, have expanded or tried to expand their activities into new fields

not traditionally related to banking. Banks lease equipment; they sell insurance; they render accounting and tax services; and they issue credit cards. They also want to expand into furnishing armored car services and travel agency services.

Bank expansion into such commercial fields has raised serious questions with respect to the permissible scope of bank activities under existing law. These activities have been or are being contested in the courts by competitors who would be directly harmed by such activities.¹

The focus of our testimony is on the increasing activities of banks in the securities business. This relates to the finding in Section 2 of the bill that, among other activities, "in marketing securities" bank holding companies "have extended their services into product markets beyond those directly related to banking, thereby eroding the line between banking and commerce in the Nation."

At the outset we wish to refer to what should be obvious. Banking interests should not be permitted to do indirectly what they are forbidden to do directly. The Bank Holding Company Act was never intended and cannot be used as an excuse to permit banking interests to avoid prohibitions elsewhere contained in the law—such as the provisions of the Glass-Steagall Act of 1933 which divorced the banking business from most aspects of the securities business.²

The expanded activity by banks in the securities industry raises two fundamental questions:

First, are the reasons that gave rise to the Glass-Steagall Act still valid today, or should the Glass-Steagall Act be amended so as to make it clear that banks may or may not engage in some or all of these securities activities?

Second, is it in the public interest to sanction the increased concentration of economic power in banks by permitting them to enter the securities business and would this create unfair competition?

Among the securities activities which the banks are engaging in, has tried to engage in, or would like to engage in, are the following:

¹ It should be noted that the Supreme Court and other federal courts have in recent years struck down a number of attempts by the Office of the Comptroller of the Currency to permit banks to engage in activities not normally associated with the banking business. For example, the Comptroller's rulings were overturned in the following cases: *Saxon v. Georgia Association of Independent Insurance Agents, Inc.*, 399 F. 2d 1010 (5th Cir. 1968) (selling life insurance); *First National Bank v. Dickinson*, 396 U.S. 122 (1969) (setting up armored car service and deposit receptacles); *Arnold Tours, Inc. v. Camp and South Shore National Bank*, 472 F. 2d 427 (1st Cir. 1972), aff'g. 338 F. Supp. 721 (D.C. Mass. 1972) (acting as travel agent); and involving interpretation of Glass-Steagall, *Investment Company Institute v. Camp*, 401 U.S. 617 (1971) (sponsoring and operating a mutual fund); *Baker, Watts & Co. v. Saxon*, 261 F. Supp. 247 (D.C.D.C. 1966), aff'd. 392 F. 2d 497 (D.C. Cir. 1968) (sale of municipal revenue bonds); *National Retailers Corporation of America v. Valley National Bank, et al.*, U.S. Dist. Ct. Ariz., Feb. 2 1976 (offering data processing services).

² Any possible thought that the 1970 amendments to the Bank Holding Company Act might be interpreted to dilute the application of the Glass-Steagall Act to a component of a bank holding company was dispelled by the following colloquy between Senators Williams and Sparkman on the Senate floor in connection with the passage of such amendments:

"Mr. WILLIAMS, of New Jersey. I have one question I should like to ask the chairman of the committee.

Both the Senate and House bills contained, in section 4(c)(8), substantially similar language reiterating the existing law embodied in the Glass-Steagall Act which provides, essentially, for separation of commercial banking and the securities business. This language does not appear in the bill agreed to by the conferees. I wonder whether there was any intention to imply that the very securities-related activities forbidden to banks directly may nevertheless be engaged in by bank-holding companies or their nonbanking affiliates.

Mr. SPARKMAN. The answer to the Senator's question is that there clearly was not. As it now stands, the Glass-Steagall Act broadly prohibits both banks and their affiliates from engaging in what we commonly understand to be the securities business. There are some specific exceptions, of course, but I can assure you that we did not mean to enlarge or contract them here. We regarded that general prohibition as being so clearly applicable to the subjects of this bill as to make a restatement of it unnecessary. . . . If Congress is to change that longstanding, fundamental statement of public policy, we will have to do so in other legislation. I hope there is no longer any misconception on that point.

Mr. WILLIAMS of New Jersey: It is reassuring, indeed, to know that the Glass-Steagall Act has not been disturbed in any way and that there is no intention at all here to do so." [116 Cong. Rec. 42430 (1970)]

(1) *Bank sponsorship and operation of open-end investment companies (mutual funds).*—This involves the creation and merchandising by banks of pooled funds for managing agency accounts—found by the courts to be the functional equivalent of mutual funds. In a suit instituted by the Investment Company Institute against the Comptroller of the Currency, this activity was held by the Supreme Court of the United States in 1971 to violate the Glass-Steagall Act (*Investment Company Institute, et al v. Camp*, 401 U.S. 617). Nevertheless, the American Bankers Association has announced its intention to seek legislation to overturn the *Camp* case and the Comptroller of the Currency has announced his support for permitting banks to enter the mutual fund business.³

(2) *Bank sponsorship of closed-end investment companies.*—In the last few years, banks have created and sponsored closed-end investment companies having hundreds of millions of dollars. This activity is presently being challenged in a suit brought in the federal district court for the District of Columbia by the Investment Company Institute against the Board of Governors of the Federal Reserve System (*Investment Company Institute v. Board of Governors of the Federal Reserve System, et al*, Civil Action No. 74-697 (July 30, 1975)). The suit, which seeks a judicial declaration that the Regulation of the Federal Reserve Board permitting such sponsorship violates the Glass-Steagall Act and the Bank Holding Company Act, has been dismissed on procedural grounds⁴ and an appeal is pending.

(3) *Bank automatic stock investment plans.*—Banks are aggressively marketing these plans under which a depositor directs the bank to withdraw monthly an amount (usually a minimum of \$20 and a maximum of \$500 per company) from his checking account to purchase shares of one or more of the 25 companies with the largest capitalization appearing in the Standard & Poor's 425 Industrial Index. The bank receives a fee for its service. The New York Stock Exchange and the Investment Company Institute have jointly brought an action in the federal district court for the District of Columbia against the Comptroller of the Currency seeking a judicial declaration that the Comptroller's regulation permitting such activity violates the Glass-Steagall Act. Summary judgment⁵ was awarded to the Comptroller and an appeal is pending.

(4) *Dividend reinvestment plans.*—Banks are aggressively merchandising these plans under which the banks for a fee will reinvest dividends of a particular corporation in the stock of the corporation and often will permit the stockholder to add up to an additional \$1,000 monthly for reinvestment by the banks in such stock.

(5) *Sponsorship of REITs.*—Banks have recently sustained huge losses in connection with real estate investment trusts because of the bank's involvement as sponsors and lenders.

(6) *Underwriting municipal revenue bonds.*—Banks are attempting to have the Glass-Steagall Act amended to permit this activity, in view of a court decision⁶ holding such activity illegal under Glass-Steagall.

It may be expected that such activities by banks in the securities business are only the beginning, if they are permitted to go on unchecked. It may not be unreasonable to anticipate that U.S. banks will ultimately seek the right to conduct a regular broker-dealer securities business and thus dominate such business as in the case of many European countries.

1. THE GLASS-STEAGALL ACT

After the Congressional study as to reasons for the stock market debacle of 1929 and ensuing depression years, Congress in 1933 passed the Glass-

³ Transcript of Hearing on Securities Activities of Commercial Banks before Subcommittee on Securities of Senate Committee on Banking, Housing and Urban Affairs, December 9-10, 1975, Vol. 1 pages 70-71 Vol. 2, pages 124-125.

⁴ 398 F. Supp. 725 (D.D.C. 1975).

⁵ *New York Stock Exchange Inc. et al v. Smith*, CCH Fed. Banking Law Rep. §96, 706 (D.D.C. Dec. 5, 1975).

⁶ See *Baker, Watts & Co. v. Saxon*, 261 F. Supp. 247 (D.C.D.C. 1966), Aff'd sub. nom., *Port of New York Authority v. Baker, Watts & Co.*, 392 F. 2d 497 (D.C. Cir. 1968).

Steagall Act which was in large part designed to divorce the banking business from the general securities business.⁷

While the securities activities of banks described above will present dangers to the public and involve conflicts of interest which are likely to differ in degree depending on the type of activity involved, a crucial fact is that these dangers and conflicts exist because banks have a "salesman's stake" in these activities.

In considering the issue of Glass-Steagall, we take as a focal point the hazards to the public which the Supreme Court of the United States found to exist in 1971 if a bank were permitted to sponsor and merchandise its own mutual fund—hazards which permeate the other bank securities activities in varying degrees of intensity.

The potential dangers to the public which result from these activities are highlighted in the Supreme Court's decision in the *Camp* case referred to above. In finding that "the potential hazards and abuses that flow from a bank's entry into the mutual fund business are the same basic hazards and abuses that Congress intended to eliminate almost forty years ago," the court pointed to specific hazards as follows:

"And there are other potential hazards of the kind Congress sought to eliminate with the passage of the Glass-Steagall Act. The bank's stake in the investment fund might distort its credit decisions or lead to unsound loans to the companies in which the fund had invested. The bank might exploit its confidential relationship with its commercial and industrial creditors for the benefit of the fund. The bank might undertake, directly or indirectly, to make its credit facilities available to the fund or to render other aid to the fund inconsistent with the best interests of the bank's depositors. The bank might make loans to facilitate the purchase of interests in the fund. The bank might divert talent and resources from its commercial banking operation to the promotion of the fund. Moreover, because the bank would have a stake in a customer's making a particular investment decision—the decision to invest in the bank's investment fund—the customer might doubt the motivation behind the bank's recommendation that he make such an investment. If the fund investment should turn out badly there would be a danger that the bank would lose the good will of those customers who had invested in the fund. It might be unlikely that disenchantment would go so far as to threaten the solvency of the bank. But because banks are dependent on the confidence of their customers, the risk would not be unreal."

Many of the same or substantially the same conflicts of interest that led to the decision in the *Camp* case involving bank-sponsored mutual funds are involved in bank automatic stock investment plans. For example, there is the temptation to lend moneys to bolster the 25 companies on the investment list or to withhold credit from competing companies; to have the bank's trust or other departments invest in such stocks to stabilize or improve their prices; and to merchandise the plan to anyone and everyone without regard to suitability to the investor, all in order to make a profit out of the service. There is the further temptation to profit from a "float" by utilizing the full 30-day "acquisition interval" permitted for buying securities after the cut-off date established by the bank.

There is also a serious question of disclosure involved in the potential conflict between the activities of a bank in purchasing securities under its widely advertised automatic investment plan and the activities of the bank's trust department in dealing in the same securities. For example, if bank customers are in the process of giving the bank millions of dollars to buy certain securities under the automatic investment plan, and at the same time the bank, having decided the outlook for those issues is not good, is in the process of selling off millions of dollars of the same securities from its trust funds and

⁷ To explain in more detail the intent of the Glass-Steagall Act in this respect, we offer to submit for the record a copy of the plaintiff's Memorandum in opposition to the defendant's motion to dismiss or for Summary Judgment, in the pending case which the New York Stock Exchange and the Investment Company Institute have brought against the Comptroller of the Currency with regard to bank automatic stock investment plans. In particular, we call the Committee's attention to pages 23 to 32 of the memorandum on the question of the intent of Glass-Steagall, as interpreted by banking authorities, with respect to banks offering brokerage services.

other investments, does not the bank have a fiduciary duty to advise its automatic investment customers that it is buying for them securities which the bank's trust department believes are not a good investment? The banks apparently deny that such a fiduciary duty exists.

We have read the press reports which indicate that some banks do not hesitate to plunge into conflicts of interest situations when they sponsor or rescue their real estate investment trusts. We do not know how valid the criticism may or may not be. However, the relationship of banks to their REITs appears to have striking similarities to the relationship before 1933 between banks and their securities affiliates, which was instrumental in bringing about the Glass-Steagall separation of banking and securities functions. If so, this is another reason for maintaining the prophylactic provisions of Glass-Steagall.

2. UNDUE CONCENTRATION OF ECONOMIC POWER IN BANKS AND UNFAIR COMPETITION

Commercial banks have acquired huge assets which carry with them a powerful capacity to dominate our nation's business and to influence our securities markets.⁸

It is a truism that banks are far and away the largest of private financial institutions. At the end of 1973, commercial banks had non-trust assets of \$755 billion and trust assets of \$378 billion. These combined commercial bank assets of \$1,133 billion exceeded the aggregate assets of all other major financial institutions, including, among others, mutual savings banks, savings and loan associations, insurance companies and mutual funds. Of these bank assets of \$1,133 billion, \$237 billion were accounted for by ownership of common stocks.

Moreover there is concentration within concentration. Fifteen commercial banks at the end of 1973 controlled 41.8% of the assets of all commercial banks.

As for potential capacity to dominate U.S. industry, it is interesting to note, for example, that at the end of 1973 New York banks alone held the following percentages of total voting stock of the following companies, to mention just a few examples: 17% of Mobil Oil, 11% of Ford Motor, 19% of Xerox, 30% of American Airlines, 30% of the Burlington & Northern Railroad, 17% of Western Union and 18% of Safeway Stores. And superimposed on such dominant stock ownership is a pervasive system of interlocking directorates between industrial corporations and banks.

This vast concentration of economic wealth and influence increases the probability that bank equity investments will flow to large corporations, creating artificial pressures for higher stock prices of the favored large corporations. The smaller firms are not big enough to satisfy the huge appetite of bank needs to invest.

One of the arguments that banks make in favor of being permitted to compete in the securities business is that they can do it better and cheaper. Even if this were true—which is doubtful—the justification for permitting banks to enter the securities business must also be measured in terms of the fairness or unfairness of the competition which would be represented by bank entry into the business. Moreover, there is no lack of competition in the securities industry today. For example, there are over 600 mutual funds being offered today to the public.

It seems clear that, apart from other impacts on the U.S. economy, if banks are permitted to compete in the securities business their concentration of economic power will produce unfair competition favoring the banks as against their competitors.

Some of the reasons for this conclusion are as follows:

⁸ See, for example, Staff Report on Financial Institution Reform, House Committee on Banking and Currency, attached to memorandum dated August 15, 1973 from Chairman Patman to all Committee members; The Role of Institutional Investors in the Stock Market—staff briefing material, dated July 24 1973, prepared for use of Subcommittee on Financial Markets of Senate Committee on Finance; Disclosure of Corporate Ownership, prepared by the Subcommittees on Intergovernmental Relations, and Budgeting, Management and Expenditures of the Senate Committee on Government Operations, December 27, 1973.

(1) Banks would have a tremendous competitive advantage because of their built-in customers and their leverage over financial decisions made by these customers. National banks have approximately 14,000 branches and over 18,000 offices throughout the country and there are many additional branches and offices maintained by state banks. Every day thousands of customers stream across the threshold of banks for the purpose of making deposits, making loans, paying off loans and taking advantage of many other banking services. The financial health, even the financial existence of many of these customers depends upon a satisfactory relationship with the bank. Under these circumstances, pressure from a bank does not have to be very direct to enable it to capture all of a customer's financial business.

(2) Not only are the customers physically present in the bank, but banks are permitted to, and do, advertise their services in a much more aggressive and liberal fashion than is permitted to financial institutions such as mutual funds that are subject to regulation by the Securities and Exchange Commission and state securities administrators. For example, when the Chase Manhattan Bank in New York began in 1973 to merchandise its automatic stock investment plan, its multi-colored promotional brochure referred to the plan as a "fantastic new way" to establish a stock investment program . . . "Just fill out the attached form . . . and you're on your way to Wall Street." Moreover, the regular monthly statements sent by Chase Manhattan to its checking account depositors were used to promote the plan by being accompanied by the same brochure and having a legend on the statement itself "Chase's Automatic Stock Investment Plan each month allows you to invest in a Selection of Stocks. Enroll Now."

The merchandising of securities services by institutions other than banks is closely regulated under federal and state law. Banks, however, are generally exempt from the provisions of the federal securities laws and probably from most state securities laws.

National banks usually argue that regulation by the Comptroller of the Currency is equivalent to regulation by the Securities and Exchange Commission. But the fact is that banking regulation is designed to protect the solvency of banks and not to protect the public investor who accepts investment advice from banks. To be sure, the activities of bank trust departments are subject to inspection by the banking authorities, but the thrust of such trust department inspection is not to protect the investor but rather to see to it that trust department activities are not mismanaged in a way that will cause the bank to be surcharged so as adversely to affect its solvency and therefore its depositors.

(3) The trust department of a bank has access to inside information not available to competitors in the investment business. Although the banks like to talk of a "Chinese Wall" between the trust department and the commercial department, there is far too much danger that the wall will be perforated—that the trust department, in choosing to make or change investments for its customers, will have the advantage of inside knowledge possessed by the commercial department concerning companies that are customers of the commercial department.

When pressure is applied the wall can obligingly disappear. For example, following the institution of fully competitive stock exchange commission rates on May 1, 1975, the extreme price cutting of commission rates raised questions as to the financial stability of brokers with whom the banks deal. According to the June 9, 1975 issue of the *Wall Street Letter*, the trust departments of large commercial banks were "discreetly" asking their commercial department to notify them about the checking and lending accounts of brokers. No such inside information is available to other financial institutions who also rely heavily on the solvency of the broker-dealers they employ.

(4) Many banks hold themselves out as investment advisers and thousands of people go to them for impartial investment advice. The inherent conflict of interest which is present when a profit-oriented bank has a salesman's stake in merchandising its own investment services will not only jeopardize the bank's ability to give impartial advice but will also produce an unfair competitive advantage. If a bank is permitted to operate and make a profit out of its own mutual fund, is it likely that the bank will recommend a competitive mutual fund to a customer seeking impartial investment advice?

Looking beyond the question of competitive advantage, there is a serious question as to what will happen to public confidence in banks if they are permitted to enter the securities business on a broad scale. For example, as the Supreme Court of the United States pointed out in the *Camp* case, if the bank is permitted to operate its own mutual fund and recommends such an investment, will customer losses in the bank's mutual fund tend to affect the customers' confidence in his bank and thus its solvency? Or what effect on a customer's confidence in his bank will there be if the customer were to discover that at the same time he is investing his money in one of the stocks offered under the bank's automatic investment plan, the bank is in the process of unloading the stock of the same corporation from its trust funds and other investments?

In conclusion, we emphasize that it is essential to preserve the integrity, and not to permit the dilution, of the Glass-Steagall Act. Moreover, the strengthening of the public benefits test, as proposed in the bill, is a distinct improvement on the standards presently applicable to the legitimacy of non-banking activities within a bank holding company structure.

We also suggest that it might be well for Congress to give some guidance to the Federal Reserve Board to assist it in determining what is or is not so "closely and directly" related to banking as to be "a proper and necessary" incident thereto. There has been too much costly litigation already with respect to the non-legitimacy of many banking activities. We think Congress should make it plain that, among other activities, the sponsorship, management and promotion by banks of their own mutual funds and of automatic stock investment plans do not meet the bill's criteria for legitimate activity by a component in a bank holding company complex.

For the foregoing reasons, we support Sections 301(a) and Section 401 of S. 2721.

The CHAIRMAN. Thank you, Mr. Augenblick. Thank both you gentlemen for very well reasoned and persuasive statements.

Mr. O'Brien, yesterday we were given an example of a bank which made loans to a customer because of the profit on an insurance sale, credit life insurance sale. In fact, a letter was read to the committee written by a banker who said that he admitted that the loan was made simply because of the profit the bank was able to make in selling credit life insurance.

What is your judgment as to whether banks may be tempted to make unsound loans to customers which buy commercial securities services from the bank?

Mr. O'Brien. I think that the temptation is there. As to whether it actually takes place, I suppose the banks would be possessed of the best information as to whether it does take place, but one would have to admit that the relationship between the commercial side of the bank and the securities purchasing selling side of the bank might give rise to such a temptation.

The CHAIRMAN. Is there any way you can gage the importance of the passage of S. 2721? The reason I ask this question is because of the scenario that you set forth this morning. It's on page 14 of your statement concerning the possibility of a few giant U.S. banks dominating virtually every source of investment capital in the country.

Mr. O'Brien. It's for that reason when you cut through everything that I do favor the legislation. One can't prove this, but if you consider the concentration of assets within the banking community today, if you consider the normal expansion which has taken place even since the 1970 and the 1956—but particularly since the 1970 law, you would have to conclude that we are in a clear trend toward further and further concentration. If that concentration of resources and

assets is also expanded to include activities which are now not directly related to the banking business, common sense tells me that that means you will have further concentration and you will have lessening of competition, higher prices conceivably, and something which is not overall in the interest of the country and the economy.

So for these reasons, that's why we have concluded that the legislation is on the right track.

The CHAIRMAN. Well, you say that may result in higher prices. Is that the principal effect on the consumer? Would there be perhaps a diminution in the availability of alternative services as time goes on?

Mr. O'BRIEN. It seems to me if you have a concentration of power in the particular area of anything for that matter, whether it's the banks or—I have to have a bias against bigness, let's put it that way. Now if you have a concentration in the area of capital, in the area of services, it therefore results in an increase in power which, in turn, can lend itself to less competition in pricing for the services and also the availability of services. It's conceivable that capital will therefore be allocated by a bank to a favored group of clients, corporations, for example, where they have loans or what have you.

But the fact is, in my judgment, it would have a tendency toward higher prices for securities services and conceivably higher prices for overall banking services as well.

The CHAIRMAN. You discuss the issue of competition in laxity and the provision in this bill to prohibit the Comptroller from approving an activity which is not directly related to banking. Do you support S. 2298, the Federal Bank Commission Act, which would create a single bank regulatory agency?

Mr. O'BRIEN. Yes. I think we would support that. It seems to me that as I look back on some of the things which have taken place over the last couple years—and I'm not talking about the securities industry here, although it's my primary consideration—when I see a Comptroller of the Currency, a FDIC, a Federal Reserve, each group developing different standards for different purposes at a different time, it would seem to me that there is a time which we have now reached where some efficiencies would result from bringing those entities together and providing a little uniformity. I firmly believe there is competition and the wrong type of competition in this area. I therefore would favor bringing that under better control.

The CHAIRMAN. Mr. Augenblick, in your statement, you refer to differences in regulation between the SEC on the one hand and the bank regulatory agencies on the other. Are the differences such as would confer a competitive advantage on banks and the securities business?

Mr. AUGENBLICK. I think they would very much so. As you know, Mr. Chairman, taking my own industry as an example, the mutual fund industry is very closely regulated by the SEC under all of the Federal securities laws and more particularly under the Investment Company Act of 1940. Now, to be sure, the Comptroller regulates the trust activities of banks and it's probably in this area that securities activities if conducted by a bank—it's in this area they would fall. The Comptroller does regulate securities activities and he regulates the giving of investment advice to some extent, but as I understand

it and as I have heard it said, when the examiners for the Comptroller go around to examine the bank and what its trust activities are, they are not examining the bank's trust department with a view to protecting the investor who invested at the suggestion of the trust department, but they are trying to make sure that the trust department has done nothing illegal which would subject the bank to surcharge and thereby to some extent jeopardize the solvency of the bank.

In other words, I'm saying the regulation is directed not to the protection of the investor, but to the protection of the depositor.

The CHAIRMAN. Now, Mr. Augenblick, some may argue—and this seems to be at least superficially an attractive argument—that bank entry into the securities business would bring more competitors into the market. After all, we have many, many banks in this country and that would mean an addition of competition.

How competitive is the securities industry now and what is the size of firms in the market as compared to banks which would enter the market? What I'm getting at, would a bank's ability to offer loans bring an unfair competitive element into the market?

Mr. AUGENBLICK. I don't think that I can speak with expertise on the issue of the banks making loans. I think I can say that with regard to activities such as the mutual fund business, the assets of the bank, of course, dwarf the assets of mutual funds, and ours is an industry in which there is tremendous competition, not only within the industry but also with other financial institutions, for the savings dollar, and our industry is by no means monolithic. Management charges are different from fund to fund. Sales charges are different from fund to fund, and there is competition, great competition in the industry.

The CHAIRMAN. Now I have one other question for you.

Mr. O'BRIEN. Mr. Chairman, may I add something to this question of competition in the securities industry as well?

The CHAIRMAN. Yes.

Mr. O'BRIEN. As you well know, the Securities Act amendments of 1975 became law last year, bringing about an entirely new environment in the industry calling for restructuring and for the elimination of fixed rates. The competition in the industry is intense. Having been in the industry myself for over 20 years, I can assure you there is no lack of competition and it is intensified now as a result of these amendments and it is likely to still further intensify. Even in terms of the capital of the industry, the capital of the industry is equal to about—of the entire industry is equal to only several banks in New York. That gives you an example of the comparison of size and the competition which we face.

The CHAIRMAN. Mr. Augenblick, you set forth a persuasive argument that securities activities of banks puts them in a basic conflict of interest situation. Isn't it true that recent experience with REIT's makes that point rather well? The bank holding companies with REIT's got into trouble. The banking subsidiaries of the holding companies bought the poor assets of the REIT's in order to prevent insolvency and to protect the bank's names. Isn't that correct?

Mr. AUGENBLICK. That's what I read in the papers and this is exactly the kind of situation that existed back just prior to the Glass-

Steagall Act. It's the same type of situation which involved a very close relationship between banks and their then existing securities subsidiaries where they supported these subsidiaries. They had investment trusts. They persuaded people to purchase shares in the investment trusts and it seems to me that from what I have read there's quite a parallel between the two.

The CHAIRMAN. Senator Garn.

Senator GARN. I have no questions, Mr. Chairman.

The CHAIRMAN. Gentlemen, I want to thank you very, very much for a most helpful presentation, very impressive presentation.

Our next panel consists of Mr. Robert McMullen, Mr. Robert Mallon, Mr. John Delany and Mr. Bernard Goldstein. As I understand it, Mr. McMullen represents the American Society of Travel Agents; Mr. Mallon, the National Auto Dealers Association; Mr. Delany on behalf of the Courier and Armored Car Industries; and Mr. Goldstein, the Association of Data Processing Organizations.

I notice there are more than four gentlemen at the table and that's fine. If you would like to introduce the people that are with you for the record perhaps they would like to get into discussion with the committee. Go right ahead.

STATEMENT OF ROBERT L. McMULLEN, PRESIDENT, AMERICAN SOCIETY OF TRAVEL AGENTS (ASTA); ACCOMPANIED BY PAUL S. QUINN

Mr. McMULLEN. Thank you, Mr. Chairman. I am accompanied by Paul S. Quinn, legal counsel, general counsel for ASTA, the American Society of Travel Agents, from the firm of Wilkinson, Cragun & Barker.

The CHAIRMAN. Very good.

Mr. McMULLEN. 25 years ago, Mr. Chairman, I opened my travel agency in Grove City, Pa. Today I still own and operate my travel agency and I am also president of the American Society of Travel Agents, which is the world's largest travel trade association with more than 7,500 members throughout the United States and Canada.

It is indeed a pleasure to be here before the committee this morning to testify with respect to a critical problem which has plagued travel agencies for more than a decade—that is, the encroachment of powerful financial institutions into our industry.

In 1963, without any hearing or notice, the Comptroller of the Currency promulgated and incorporated into his Manual for National Banks, an interpretive ruling which purported to authorize the operation of travel agencies by national banks. Following the promulgation of that ruling, which was adamantly opposed by independent travel agents throughout the Nation, large numbers of national banks entered the travel agency business, most often through the acquisition of existing travel agencies.

On May 8, 1967, 42 independent travel agencies filed suit in the U.S. District Court for the District of Massachusetts, seeking an injunction against the operation of a travel agency by the South Shore Bank and a declaratory judgment to the effect that section

7.7475 of the Comptroller's Manual for National Banks was invalid under the National Bank Act.

After 5 years of litigation on the threshold issue of legal standing, the case was remanded to the District Court, which ruled on February 22, 1972, that the operation of travel agencies by national banks was clearly illegal and that the Comptroller's ruling was clearly invalid. That decision was affirmed by the Court of Appeals on December 13, 1972.

Mr. Carl L. Helgren, my predecessor as president of ASTA, appeared nine months later before the House Committee on Banking, Currency, and Housing which was at the time considering bank regulatory reform legislation. After recounting the protracted history of the Arnold Tours litigation, Mr. Halgren expressed the following concern:

Still, at this late date, the Comptroller has not complied with the clear mandate of the federal courts. No action has been taken to require national banks to divest themselves of all travel agency operations.

That statement, Mr. Chairman, was made on September 19, 1973. Today, 2½ years later, the Comptroller has still failed to comply with the clear mandate of the Federal courts.

On December 21, 1973, the Comptroller issued an "invitation for comments" on the matter of banks in travel.

Another year and a half passed without any action whatsoever on the part of the Comptroller's Office. Repeated inquiries on the part of ASTA and individual travel agents as to when some such action might be expected were ignored by the Comptroller's Office. National banks across the country continued undeterred in their operation of travel agencies. Finally, having exhausted every conceivable administrative and judicial avenue short of initiating more than 120 individual lawsuits throughout the National ASTA filed suit in the U.S. District Court for the District of Columbia on March 18, 1975. In that suit, ASTA sought the issuance of a writ in the nature of mandamus to compel the Comptroller to bring his manual into compliance with the National Bank Act as construed by the courts.

On March 28, 1975, 10 days after the institution of that lawsuit, the Comptroller's Office issued a "proposed revised interpretive ruling." On May 18, 1975, the Comptroller filed a motion with the U.S. District Court here in Washington, asking the court to dismiss ASTA's complaint.

On October 2, 1975, counsel for the Comptroller indicated that the Comptroller had still done nothing with respect to the matter of national bank involvement in the travel agency business. The court characterized the defendant's delay in this matter as "unbelievable," and instructed counsel for the Comptroller to tell his client to resolve the matter "in 2 weeks." A further status hearing was scheduled for October 17, 1975.

On that day, counsel for the Comptroller was obliged once again to inform the court that his client had failed to take any action whatsoever with respect to the matter in controversy. He indicated, however, that he had been authorized to represent to the court that final action would be taken by the Comptroller on or before November

28, 1975. The court thereupon issued the following order: "That the defendant Comptroller of the Currency shall either issue a revised interpretive ruling on travel services or repeal the existing ruling, on or before November 28, 1975..."

On November 28, 1975, the Comptroller issued a "notice" in which he announced that "The Comptroller intends to issue a revised interpretive ruling on this subject. Pending the issuance of such a ruling, national banks should consult with their own legal counsel as to the range of permissible travel services under applicable statutes."

I think that you will agree, Mr. Chairman, that at this late date and after 9 years of expensive litigation, the continued delay on the part of the Comptroller with respect to this matter is absolutely shocking.

In ASTA's view, the arrogance of the Comptroller of the Currency on this issue and his blatant disregard for our Federal courts does much to explain the public's loss of confidence in our bank regulators and to emphasize the urgent need to abolish the Office of the Comptroller and impose upon our financial institutions a new system of regulation which will be responsive to the Congress, the courts, and the needs of the public. It is for that reason that ASTA fully supports S. 2298.

At this time, Mr. Chairman, I would like to turn my attention from national banks to bank holding companies. As I have indicated, national bank involvement in the travel business was first declared to be illegal in February of 1972. That decision by the U.S. District Court for the District of Massachusetts was one in a long line of court decisions striking down the expansionist rulings which flowed from the Comptroller's Office in 1963.

It was largely as a result of those uniformly successful legal challenges by adversely affected competitors that national banks began to look to the one-bank holding company as a device by which to avoid judicial scrutiny of their involvement in a variety of nonbank activities. Indeed, then-Comptroller of the Currency Camp emphasized this point in testimony before the Banking Committees of both the Senate and the House of Representatives at hearings held in connection with the 1970 amendments to the Bank Holding Company Act.

In testifying before the Senate Committee on Banking and Currency, Mr. Camp stated:

Commercial banks, tiring of the continual harassment from litigation, brought by a variety of non-bank competitors, attempted to devise an organization form which might be immune from such suits. The device of creating a parent holding company, under whose corporate umbrella a number of bank operations could be spun off as holding company subsidiaries, seemed to provide a possible answer.

I am pleased to report, Mr. Chairman, that the Board of Governors of the Federal Reserve System has recently completed a rulemaking proceeding in which it considered the question of whether bank holding companies may engage in the travel agency business. The Board of Governors concluded that the operation of a travel agency is not closely related to banking or managing or controlling banks and therefore not a permissible activity for bank holding companies.

In light of that decision, Mr. Chairman, it seems clear that the possibility of entry of new bank holding companies into the travel business has been foreclosed and that all bank holding companies currently engaged in the business will be required to terminate such activities by 1980 unless they hold grandfather rights under the 1970 amendments. I sincerely hope, Mr. Chairman, that, insofar as the travel agency industry is concerned, the question of bank holding company activities under section 4(c) (8) of the Bank Holding Company Act has been resolved.

However, I would like to express ASTA's full support for S. 2721 and for the Financial Institutions Act of 1975, as well as S. 2298. As a small businessman in an industry which has faced and continues to face competition from large financial institutions, I am deeply sympathetic to the plight of the independent insurance agent, the mutual life insurance underwriter, the mortgage guarantee insurance underwriter, the automobile lessor, the courier service operator, the data processor, the custom broker, and the other small businessmen engaged in industries into which the Federal Reserve Board has authorized bank holding company expansion. My colleagues in those service industries are, it seems to me, engaged in prolonged and expensive struggles not dissimilar from ASTA's ongoing struggle with the Comptroller of the Currency. In light of the Federal Reserve Board's expansive interpretations of section 4(c) (8), it is my view that additional legislation is necessary to protect those small businessmen.

Referring once again to the legislative history of the 1970 amendments to the Bank Holding Company Act, I would point out that the statement of the house managers expressed the opinion that the closely related language of section 4(c) (8)—

*** should be interpreted to mean that there must be a direct and significant connection between the activities of the company proposed to be acquired and banking as generally carried on or between the activities of the company proposed to be acquired and managing or controlling banks as generally carried on.

Unfortunately, the Federal Reserve Board has refused to accept and implement that interpretation. In light of the expansionist attitude of the Federal Reserve Board in areas other than the travel industry, we believe that this committee should recommend enactment of an amendment to the Bank Holding Company Act which would expressly require a finding that any given activity be directly related to banking and managing or controlling banks. It appears to me that only the implementation of such an additional requirement will serve effectively to restrain the expansion of those powerful financial institutions into commercial nonbanking activities.

There is absolutely no way that an independent travel agency can effectively compete with such an operation. The impact upon area travel agents of that bank's entry into the travel business was direct and substantial. And again, while I am no banking expert, I find it difficult indeed to believe that an operation such as that can be considered to be consistent with sound banking practices.

In the Bank of America situation, the Nation's largest commercial bank undertook to create a so-called travel club in conjunction with a local travel agency, whereby a wide variety of travel services and

products were to be made available to members. The bank invested approximately \$1 million in the travel club before it ever began operation, and had undertaken a substantial, ongoing financial commitment beyond that. It also assumed a very significant degree of control over the travel services and products to be offered through the club. The vast advertising resources of the bank were also to be made available for the promotion of travel club programs. Clearly, the Bank of America travel club presented an extremely severe competitive threat to independent area travel agents.

ASTA and a number of individual travel agents in California challenged the legality of the proposed program in the U.S. District Court for the Northern District of California. In ruling that the Bank of America program did in fact violate the National Bank Act.

Another example of the aggressive travel promotion campaigns of large and powerful banks are the brochures which I have here with me today. The Indiana National Bank has recently sent copies of these fancy and expensive promotional materials to thousands of its customers, promoting a series of Caribbean and Mediterranean cruises and airline charter flights. I would like to submit these materials for the record.

The CHAIRMAN. Without objection, those will be accepted for the record [see p. 175].

Mr. McMULLEN. Thank you, Mr. Chairman.

Mr. Chairman, I would like to address myself very briefly to the need to bring about uniformity between the standards governing the entry of national banks into bank-related fields and those governing such entry by bank holding companies. I believe that the travel agency industry dramatically illustrates the need for such a reform. The irresponsible attitude of the Comptroller of the Currency is directly responsible for the continued engagement of a number of national banks in our industry. This engagement continues despite rulings by three courts to the effect that the activity is illegal. It is, I believe, especially ironic that, on the one hand, the Comptroller continues to refuse to bring about the elimination of this illegal activity on the part of national banks while, on the other hand, the Federal Reserve Board—interpreting what I understand is a broader and more permissive statute—has specifically ruled that the very same activity is not a permissible activity for bank holding companies.

Finally, Mr. Chairman, I would like to endorse and express ASTA's support for the procedural aspects of S. 2721. We believe, as you suggested in your February 24 letter, that Federal Reserve Board rulemaking proceedings under section 4(c)(8) should be conducted on the record after opportunity for hearing and full cross-examination. In fact, when ASTA became involved in the recently concluded travel agency proceeding at the Federal Reserve Board, it specifically requested that the proceeding be so conducted. Our request was denied. Fortunately, in our case, we were not adversely affected in the final analysis. However, it is my understanding that other groups of small nonbanking businessmen have made similar requests, the denial of which may well have contributed to the ultimately adverse rulings by the Board. If the facts surrounding such a proceeding are to be fully explored and considered, I believe that a

hearing such as would be required by S. 2721 is necessary. ASTA also believes that such proceedings should be specifically made subject to the protections afforded by the Administrative Procedure Act, and therefore endorses section 601 of S. 2721.

In concluding, Mr. Chairman, I would like to thank you and the members of this committee for the opportunity to appear before the committee today on behalf of ASTA, the travel agency industry, and small businessmen throughout the Nation. Vigorous and ongoing efforts to create and maintain a healthy and vital economic environment are essential to the welfare of our small business community. Your recognition of the unfortunate situation which has developed in the area of bank regulation is especially important at this time—not only within my own industry but in many other industries which have appeared and which will be appearing before this committee.

We do not fear competition—we welcome it. But competition must be fair and evenhanded. For this reason, the Congress must act now to reassert its leadership, thus assuring that the tradition of separating banking from commerce—a tradition as old as this country itself—is maintained. This, in turn, will assure the public benefits which flow from a sound banking system and a free and competitive environment for our business community.

I hope that my comments will be helpful to you in the performance of your most difficult and important task, and I request that the full written statement be made a part of your record.

The CHAIRMAN. Thank you very much, Mr. McMullen.

[Complete statement and additional material from Mr. McMullen follow:]

STATEMENT OF ROBERT L. McMULLEN, PRESIDENT AND CHAIRMAN OF THE BOARD OF THE AMERICAN SOCIETY OF TRAVEL AGENTS, INC.

Mr. Chairman, Members of the Committee: My name is Robert L. McMullen. I am a travel agent from Grove City, Pennsylvania, and along with my wife, own and operate travel agencies in Grove City, Franklin and Butler, Pennsylvania. I am also President of the American Society of Travel Agents, Inc. (ASTA), the world's largest trade association in the field of travel and tourism, with more than 7,500 travel agents members throughout the United States and Canada. I am accompanied this morning by Paul S. Quinn, a partner in the Washington law firm of Wilkinson, Cragun & Barker, general counsel to ASTA.

It is a pleasure, Mr. Chairman, to appear before your Committee this morning to testify with respect to a critical problem which has plagued the travel agency industry for more than a decade—that is, the encroachment of powerful financial institutions into many non-banking industries, including my own. Before addressing myself to the specific issues which you outlined in your letter of invitation to these hearings, I believe that it would be appropriate and useful for me to relate to the Committee the history of bank and bank holding company involvement in my own industry. That history, I believe, will graphically illustrate the need for prompt reform in the regulation of this nation's financial institutions.

In 1963, without any hearing whatsoever, the Comptroller of the Currency promulgated and incorporated into his Manual for National Banks in interpretive ruling which purported to authorize the operation of travel agencies by national banks. Following the promulgation of that ruling, which was adamantly opposed by independent travel agents throughout the nation, large numbers of national banks entered the travel agency business, most often through the acquisition of existing travel agencies.

In November of 1966, the South Shore National Bank of Quincy, Massachusetts, acquired by purchase the Wellesley Travel Service of Wellesley, Massa-

chusetts. Bank travel offices were thereupon established at three locations in the Boston vicinity, each located adjacent to or actually within an office of the South Shore bank. Almost immediately, independent travel agencies in the area began to lose customers and business to the bank-funded South Shore travel agency operation. On May 8, 1967, forty-two independent travel agencies filed suit in the United States District Court for the District of Massachusetts, seeking an injunction against the operation of a travel agency by the South Shore bank and a declaratory judgment to the effect that Section 7.7475 of the Comptroller's Manual for National Banks was invalid under the National Bank Act.

The plaintiffs in that suit (*Arnold Tours, Inc. v. Camp*) were provided with legal and financial assistance by ASTA, and, at all stages of that long and expensive litigation, ASTA actively assisted the plaintiffs and participated in all discussions involving strategy and the conduct of the litigation. ASTA did not itself join as a plaintiff because of the uncertainty which existed at the time concerning the standing of a trade association of competitors to challenge the legality of the non-banking activities of national banks.

The District Court dismissed the suit in 1968 on the ground that the plaintiff travel agencies lacked legal standing to bring the suit. The Court of Appeals for the First Circuit affirmed that ruling in 1969. In 1970, the Supreme Court vacated the judgment of the Court of Appeals and remanded the case for further consideration of the standing issue. The Court of Appeals reaffirmed the dismissal of the suit, again holding that plaintiffs lacked standing to sue. The case again went to the Supreme Court, which held that plaintiffs did indeed have standing to challenge the bank's activity and the Comptroller's ruling. The Supreme Court's decision has become a landmark decision on the issue of legal standing and has been relied upon by other small businessmen challenging illegal government action.

The case was remanded to the District Court, which ruled on February 22, 1972, that the operation of travel agencies by national banks was clearly illegal and that the Comptroller's ruling was clearly invalid. That decision was affirmed by the Court of Appeals on December 13, 1972.

Nine months later, Mr. Carl L. Helgren, my predecessor as president of ASTA, appeared before the House of Representatives Committee on Banking and Currency, which was at the time considering bank regulatory reform legislation. After recounting the history and course of the protracted *Arnold Tours* litigation, Mr. Helgren expressed the following concern:

"Yet, Mr. Chairman, despite all the time, money and effort devoted by ASTA to this crusade to assure a healthy, competitive atmosphere in the travel agency industry, the battle is *still* not over. . . . Still, at this late date, the Comptroller has not complied with the clear mandate of the federal courts. No action has been taken to require national banks to divest themselves of all travel agency operations."

* * * * *

"Needless to say, ASTA has been greatly disappointed by the insensitive and oftentimes careless approach taken by previous Comptrollers of the Currency with respect to regulation of nonbank activities by national banks. The appointment and confirmation of a new Comptroller gave rise to hopes that conditions would approve. We do believe, however, that Comptroller Smith has now had more than ample opportunity to act affirmatively and decisively and to show his good faith by complying with the mandate of the Court of Appeals. Yet, he has failed to act. . . ."

That statement, Mr. Chairman, was made on September 19, 1973. Today, two and one-half years later, the Comptroller has still failed to comply with the clear mandate of the federal courts.

On December 21, 1973, the Comptroller issued an "invitation for comments" on the matter of banks in travel. In that rather curious publication, the Comptroller stated that his delay in acting to implement the decisions of the *Arnold Tours* courts was due to "an unforeseen difficulty in defining the term 'full-scale travel agency.'"

In comments filed with the Comptroller on January 31, 1974, ASTA noted: "The significance which the Comptroller of the Currency has placed upon the term 'full-scale travel agency' in his invitation for comments cannot be

justified in light of the opinions of the United States District Court for the District of Massachusetts and the United States Court of Appeals for the First Circuit in the *Arnold Tours* case. That term has no legal or economic significance in and of itself, and the courts which decided the *Arnold Tours* case clearly did not intend to invest the term with any such significance. The activities of the South Shore National Bank, which were held in the *Arnold Tours* decisions to be in violation of the National Bank Act, were struck down not because they cumulatively amounted to the operation of a "full-scale travel agency", but rather because they were not "such incidental powers as shall be necessary to carry on the business of banking. . . ." This distinction is crucial, and must be borne in mind by the Comptroller as he complies with the judicial mandate to revise 12 C.F.R. § 7.7475, that section of the Comptroller's Manual which is the basis for national banks' acting as travel agents."

Another year and a half passed without any action whatsoever on the part of the Comptroller's office. Repeated inquiries on the part of ASTA and individual travel agents as to when some such action might be expected were ignored by the Comptroller's office. National banks across the country continued undeterred in their operation of travel agencies. Finally, having exhausted every conceivable administrative and judicial avenue short of initiating more than 120 individual lawsuits throughout the nation, ASTA filed suit in the United States District Court for the District of Columbia on March 18, 1975. In that suit, ASTA sought the issuance of a writ in the nature of mandamus to compel the Comptroller to bring his Manual into compliance with the National Bank Act as construed by the courts.

On March 28, 1975, ten days after the institution of that lawsuit, the Comptroller's office issued a "proposed revised Interpretive Ruling." The explanatory note to that notice and the press release which accompanied its issuance indicated that, under the proposed rule, national banks would continue to be permitted to sell transportation tickets. The actual proposed rule did not contain such a reference, but rather, would permit national banks to "[act] as collection agent for a steamship, railroad, airline or other company."

The April 7, 1975 issue of *The Travel Agent*, a trade publication, reported that:

"David Oppenheimer, an attorney with the Comptroller's office, said the language in the proposed rulemaking means national banks could 'belong to a carrier conference, fill out tickets and get commissions for selling them.' . . ."

Mr Oppenheimer expressed the same opinion in a telephone conversation with ASTA's general counsel that same week, and further indicated that the ruling was intended to permit the banks to "continue operating their agencies . . . and compete with the independent agent."

On April 8, 1975, Mr. Quinn wrote to Mr. Robert Bloom, who was at the time chief counsel to the Comptroller, asking for a clarification of what the Comptroller's office intended to authorize by the proposed rule. Specifically, he asked Mr. Bloom either to acknowledge or disclaim the interpretation which Mr. Oppenheimer had expressed. By letter of April 24, 1975, Mr. Bloom declined to provide any clarification of the "proposed revised Interpretive Ruling", indicating that his office did "not think it would be advisable to issue written interpretations of the proposal prior to its adoption in final form."

On May 1, 1975, ASTA filed comments with respect to the "proposed revised Interpretive Ruling."

On May 18, 1975, the Comptroller filed a motion with the U.S. District Court here in Washington, asking the court to dismiss ASTA's complaint or, in the alternative, for summary judgment. ASTA opposed that motion on June 18, 1975, and the Court thereupon scheduled a status hearing for June 25, 1975. At that hearing, counsel for the Comptroller indicated that he had been told by representatives of the Comptroller's office that it would probably take appropriate final action with respect to the matter of national banks in the travel business "sometime in July." The Court then scheduled a second status hearing for August 18, 1975. That hearing was later cancelled by the Court, and subsequently rescheduled for October 2, 1975.

On October 2, 1975, counsel for the Comptroller indicated that the Comptroller had still done nothing with respect to the matter of national bank involvement in the travel agency business. The Court characterized the defendant's delay in this matter as "unbelievable", and instructed counsel for

the Comptroller to tell his client to resolve the matter "in two weeks". A further status hearing was scheduled for October 17, 1975.

On October 17, 1975, counsel for the Comptroller was obliged once again to inform the Court that his client had failed to take any action whatsoever with respect to the matter in controversy. He indicated, however, that he had been authorized to represent to the Court that final action would be taken by the Comptroller on or before November 28, 1975. The Court thereupon issued the following order:

Upon the representation made this day in open court by counsel for the defendant Comptroller, it is hereby Ordered

That the defendant Comptroller of the Currency shall either issue a revised interpretive ruling on travel services or repeal the existing ruling, on or before November 28, 1975.

On November 28, 1975, the Comptroller issued a "notice" in which he announced that:

"... the existing language of I.R. 7.7475, 12 C.F.R. 7.7475, is this day rescinded.

"The Comptroller intends to issue a revised interpretive ruling on this subject. *Pending the issuance of such a ruling, national banks should consult with their own legal counsel as to the range of permissible travel services under applicable statutes.*" (Emphasis added.)

Upon the issuance of that announcement, it was reported in the December 8, 1975 issue of *Travel Weekly* (another prominent trade publication) that:

A spokesman for the comptroller said, "The banks are now on their own. They can do whatever they feel is legal."

Although Smith said he intends to issue a revised regulation in the future, the spokesman said the matter "isn't on the hottest burner on the stove." He said the ruling probably won't be out before the end of next year.

I think that you will agree, Mr. Chairman, that at this late date and after nine years of expensive litigation, such statements by a spokesman for the Comptroller are absolutely shocking.

By letter of December 5, 1975, ASTA's general counsel indicated to the Court and to counsel for the Comptroller that they believed the "notice" to be entirely unsatisfactory, and requested that a further status hearing be scheduled for the purpose of establishing an appropriate schedule for the completion of discovery in the case. The Court scheduled such a status hearing for December 18, 1975.

The Comptroller renewed his motion to dismiss on December 15, 1975. At the December 18 status hearing, the Court stayed all of ASTA's requests for discovery in the case pending its disposition of the Comptroller's renewed motion, and instructed ASTA's counsel to submit a response to that renewed motion on or before January 12, 1976. ASTA's counsel did so, and the matter is presently pending before the Court.

Mr. Chairman, it would indeed be an understatement to say that I and the more than 7,500 travel agents whom I represent this morning feel extremely frustrated at the continued involvement of national banks in our industry. We have litigated this matter—at tremendous expense—for nine years. We have won every legal battle. Yet the Comptroller continues even today to engage in a defiant and unreasonable war of attrition.

In ASTA's view, the arrogance of the Comptroller of the Currency on this issue and his blatant disregard for our federal courts does much to explain the public's loss of confidence in our bank regulators and to emphasize the urgent need to abolish the office of the Comptroller and impose upon our financial institutions a new system of regulation which will be responsive to the Congress, the courts, and the need of the public.

At this time, Mr. Chairman, I would like to turn my attention from national banks to bank holding companies. As I have indicated, national bank involvement in the travel business was first declared to be illegal in February of 1972. That decision by the United States District Court for the District of Massachusetts was one in a long line of court decisions striking down the expansionist rulings which flowed from the Comptroller's office in 1963. In affirming the decision of the District Court, the United States Court of Appeals for the First Circuit noted that:

"Every one of these other 1963 rulings which have been challenged on their merits have subsequently been struck down by the courts. Saxon's 1963 ruling that national banks could enter the insurance business was overturned in *Georgia Ass'n of Independent Ins. Agents, Inc. v. Saxon*, 268 F. Supp. 236 (N.D. Ga. 1967), *aff'd*, 399 F.2d 1010 (5th Cir. 1968). Saxon's 1963 ruling that national banks could underwrite government securities was invalidated in *Baker, Watts & Co. v. Saxon*, 261 F. Supp. 247 (D.D.C. 1966), *aff'd*, 129 U.S. App. D.C. 173, 392 F.2d 497 (1968). His 1963 ruling that national banks could operate a mutual investment fund was set aside in *Investment Company Institute v. Camp*, 401 U.S. 617 . . . (1971). His 1963 ruling that national banks could set up an armored car service and deposit receptacles at various locations despite state branch banking laws was overturned in *First National Bank v. Dickinson*, 396 U.S. 122 . . . (1969)."

Arnold Tours, Inc. v. Camp, 472 F.2d 427, 436, n.12 (1st Cir. 1972).

It was largely as a result of those uniformly successful legal challenges by adversely affected competitors that national banks began to look to the one-bank holding company as a device by which to avoid judicial scrutiny of their involvement in a variety of non-bank activities. Indeed, then-Comptroller of the Currency Camp emphasized this point in testimony before the banking committees of both the Senate and the House of Representatives at hearings held in connection with the 1970 amendments to the Bank Holding Company Act.

Mr. Camp was questioned by the current Chairman of the House Banking and Currency Committee about a speech he made on September 30, 1968, to the American Bankers Association at its annual convention. During that speech, which is reproduced at pages 1236-1238 of the transcript of the House hearings, he stated:

"One of the most notable phenomena of recent years has been the lateral expansion of banking into allied fields of finance. To carry out this expansion, an increasing number of banks have found it more suitable and more efficient to form one-bank holding companies. Rivals who have found little success in attacking the substantive basis of these expanded activities have now in some instances deployed their forces against the organizational measures employed in their performance. But there should be no mistake about their real objective.

"These developments in banking have coincided with a greatly expanded use of the conglomerate form of organization in other forms of enterprise. But it is an interesting fact that the acquisition of banks by nonfinancial organizations has not yet aroused the same opposition as comparable actions on the part of banks. Most serious in its implications is the suggestion that a one-bank holding company should come under the controls of the Holding Company Act."

In testifying before the Senate Committee on Banking and Currency, Mr. Camp was even more explicit in stating his view that the one-bank holding company loophole was a good device for banks to use to avoid complying with judicial mandates which otherwise would restrict their activities to those necessary and incidental to banking. Specifically, after discussing some of the litigation which his rulings had generated, he stated:

"What has all this to do with the immediate issue before the Committee? Commercial banks, tiring of the continual harassment from litigation, brought by a variety of non-bank competitors, attempted to devise an organization form which might be immune from such suits. The device of creating a parent holding company, under whose corporate umbrella a number of bank operations could be spun off as holding company subsidiaries, seemed to provide a possible answer."

If the Comptroller's testimony contained a note of trepidation about the effect of judicial challenges upon his rulings authorizing non-bank activities for national banks, it was with good cause. In every single instance where a ruling of the Comptroller authorizing non-banking activities by banks had been challenged in court, the Comptroller was struck down.

I am pleased to report, Mr. Chairman, that the Board of Governors of the Federal Reserve System has recently completed a rulemaking proceeding in which it considered the question of whether bank holding companies may engage in the travel agency business. The Board of Governors concluded:

"It is the Board's view, in light of the above and other facts of record, that there exists an insufficient historical relationship between [the operation of a travel agency] and the general nature of banking activities to meet the closely related test of § 4(c) (8). Neither does the Board conclude that the proposed activity is functionally or integrally related to other banking activities which have previously been found to be permissible within the tests set forth in the *Courier* decision. Accordingly, the Board finds that the operation of a travel agency is not closely related to banking or managing or controlling banks."

In light of that decision, Mr. Chairman, it seems clear that the possibility of entry of new bank holding companies into the travel business has been foreclosed and that all bank holding companies currently engaged in the business will be required to terminate such activities by 1980 unless they hold total grandfather rights under the 1970 amendments. I sincerely hope, Mr. Chairman, that, insofar as the travel agency industry is concerned, the question of bank holding company activities under Section 4(c) (8) of the Bank Holding Company Act has been resolved.

However, I would like to express ASTA's full support for S. 2721 and for the Financial Institutions Act of 1975, S. 1267. As a small business man in an industry which has faced and continues to face competition from large financial institutions, I am deeply sympathetic to the plight of the independent insurance agent, the mutual life insurance underwriter, the mortgage guarantee insurance underwriter, the automobile lessor, the courier service operator, the data processor, the custom broker, and the other small businessmen engaged in industries into which the Federal Reserve Board has authorized bank holding company expansion. My colleagues in those service industries are, it seems to me, engaged in prolonged and expensive struggles not entirely dissimilar from ASTA's ongoing struggle with the Comptroller of the Currency. In light of the Federal Reserve Board's expansive interpretations of Section 4(c) (8), it is my view that additional legislation is necessary to protect those small businessmen.

Banks and bank holding companies should, we believe, be restricted to activities "directly" related to banking. ASTA has always believed—and the courts and the Federal Reserve Board have agreed—that the travel agency business is entirely unrelated to banking or to managing and controlling banks. Other industries, such as those to which I have referred, involve businesses which (while the question may not be as clear-cut as in our industry)¹ would certainly appear to be beyond the proper domain of banks and bank holding companies. Referring once again to the legislative history of the 1970 amendments to the Bank Holding Company Act, I would point out that the Statement of the House Managers expressed the opinion that the "closely related" language of Section 4(c) (8) "... should be interpreted to mean that there must be a *direct and significant connection* between the activities of the company proposed to be acquired and banking as generally carried on or between the activities of the company proposed to be acquired and managing or controlling banks as generally carried on." H.R. Rep. No. 91-1747, 91st Cong. 2nd Sess. 21 (Emphasis added). Unfortunately, the Federal Reserve Board has refused to accept and implement that interpretation. In light of the expansionist attitude of the Federal Reserve Board in areas other than the travel industry, we believe that this Committee should recommend enactment of an amendment to the Bank Holding Company Act which would expressly require a finding that any given activity be "directly" related to banking and managing or controlling banks. It appears to me that only the implementation of such an additional requirement will serve effectively to restrain the expansion of those powerful financial institutions into commercial non-banking activities.

From the perspective of small businessman, Mr. Chairman, I would say, in answer to the third issue raised in your letter of February 24, that it is absolutely necessary for this Committee and the Congress to consider unfair competition, undue concentration of resources and conflicts of interests in connection with the possible reform of our banking laws. The two banks-in-travel situations with which I am most familiar—the South Shore National Bank acquisition

¹ During the course of hearings held by the House Committee on Banking and Currency, in connection with the 1970 Bank Holding Company Act amendments the Honorable Wright Patman, Chairman of the Committee remarked: "Now, the travel agencies are just as far removed from actual banking, the way I see it, as most any business that you could give us as an example."

which I referred to earlier and the more recent attempt by the Bank of America to establish a "travel club" (also challenged successfully by ASTA in the courts) illustrate this necessity.

As I have indicated, the South Shore National Bank acquired a large and successful travel agency in Massachusetts and opened three travel locations in the Boston area. It immediately instituted an extensive and intensive advertising campaign, and independent travel agencies in the area began to lose customers and business to the bank operation almost immediately.

In the calendar year 1967, the South Shore travel department sustained direct losses of at least \$110,000; in 1968 it lost \$40,000; in 1969 it lost \$10,000; and in 1970 it lost \$30,000. Moreover, the travel department incurred substantial expenses which are not reflected in these loss figures, since they were written off by the bank to different accounts. Some of the travel department's advertising expenses, for example, were so handled. Certainly, an independent travel agency could not operate with such losses. And, as a member of the board of directors of a small bank in my community. I know that such losses could not help but undermine the bank's financial stability and public image.

The bank expended very large sums of money during the 1967-1970 period for advertising its travel operation. The advertising campaign used virtually every major advertising medium, including billboards, radio, newspapers, signs, buttons, brochures, inserts in bank statements and inserts in savings club statements.

The bank actively solicited business from its own customers, from prospective bank customers, and from mailing lists furnished to it from various sources. Travel solicitations were made of persons whose names appeared on confidential records of its trust department.

The South Shore bank actively solicited travel accounts away from independent travel agencies, and in many instances was successful in its efforts. Despite the fact that it was losing money, the bank travel department increased the number of its employees from 13 to 28 between 1967 and 1970.

There is absolutely no way that an independent travel agency can effectively compete with such an operation. The impact upon area travel agents of that bank's entry into the travel business was direct and substantial. And again, while I am no banking expert, I find it difficult indeed to believe that an operation such as that can be considered to be consistent with sound banking practices.

In the Bank of America situation, the nation's largest commercial bank undertook to create a so-called "travel club" in conjunction with a local travel agency, whereby a wide variety of travel services and products were to be made available to members. Membership in the club was available for the payment of a nominal fee to the bank, and entitled a customer to free traveler's checks, automobile rental discounts, the issuance of a bank-affiliated BankAmericard and an in-house periodical, as well as access to the travel services and products which were arranged and packaged through the contracting travel agency. The bank invested approximately \$1,000,000.00 in the "travel club" before it ever began operation, and had undertaken a substantial, ongoing financial commitment beyond that. It also assumed a very significant degree of control over the travel services and products to be offered through the "club". The vast advertising resources of the bank were also to be made available for the promotion of "travel club" programs. Clearly, the Bank of America "travel club" presented an extremely severe competitive threat to independent area travel agents.

ASTA and a number of individual travel agents in California challenged the legality of the proposed program in the United States District Court for the Northern District of California. In ruling that the Bank of America program did in fact violate the National Bank Act, the Court noted:

Through the National Bank Act Congress sought to shelter banking institutions from at least some of the forces of the market which might undermine public confidence in the banks and ultimately threaten their existence. History has taught us the disastrous consequences which follow when banks are weakened and public confidence in them undermined. National banks are denied the opportunity to earn a profit through investing in ventures unrelated to the business of banking not simply because they might unfairly compete in other industries, but because the pursuit of profit in fields unrelated to banking could

tempt bankers to make unwise or improvident decisions and thus could threaten the strength and stability Congress sought to instill in the banking industry. . . .

* * * * *

Because the Bank of America is committed under the contract to cover Pathways' expenses (subject to repayment from earnings) and to indemnify Pathways and its officers and directors from whatever losses they might incur because of their involvement with the travel club, the Bank of America has a substantial interest in the financial success and competent management of Pathways. Pressures exist, therefore, for the Bank of America to risk large advances of funds to Pathways if the venture begins to falter and to lower standards for granting consumer credit for travel expenses to "prime the pump" of the travel industry. . . .

* * * * *

Whether or not the Bank of America plays a profit-making role in its relationship with Pathways, if the bank assumes the financial risks of the venture and if it otherwise associates with it the bank's name and reputation, then the Bank of America is engaged in the travel bureau business within the meaning of the National Bank Act. The test must not be whether the bank is making a profit from the enterprise, but whether the bank has so closely associated itself with the venture as to create the dangers Congress sought to foreclose with the National Bank Act. . . .

American Society of Travel Agents, Inc. v. Bank of America National Trust and Savings Ass'n, 385 F. Supp. 1084, 1089-91 (N.D. Cal. 1974).

Another example of the aggressive travel promotion campaigns of large and powerful banks are the brochures which I have here with me today. The Indiana National Bank has recently sent copies of these fancy and expensive promotional materials to its thousands of customers, promoting a series of Caribbean and Mediterranean cruises and airline charter flights. I would like to submit these materials for the record.

Mr. Chairman, I would like to address myself very briefly to the need to bring about uniformity between the standards governing the entry of national banks into bank-related fields and those governing such entry by bank holding companies. I believe that the travel agency industry dramatically illustrates the need for such a reform. The irresponsible attitude of the Comptroller of the Currency is directly responsible for the continued engagement of a large number of national banks in our industry. This engagement continues despite rulings by three courts to the effect that the activity is illegal. It is, I believe, especially ironic that, on the one hand, the Comptroller continues to refuse to bring about the elimination of this illegal activity on the part of national banks while, on the other hand, the Federal Reserve Board—interpreting what I have been told is a broader and more permissive statute—has specifically ruled that the very same activity is not a permissible activity for bank holding companies.

Finally, Mr. Chairman, I would like to endorse and express ASTA's support for the procedural aspects of S. 2721. We believe, as you suggested in your February 24 letter, that Federal Reserve Board rulemaking proceedings under Section 4(c) (8) should "be conducted on the record after opportunity for hearing and full-cross examination." In fact, when ASTA became involved in the recently concluded travel agency proceeding at the Federal Reserve Board, it specifically requested that the proceeding be so conducted. Our request was denied. Fortunately, in our case, we were not adversely affected in the final analysis. However, it is my understanding that other groups of small non-banking businessmen have made similar requests, the denial of which may well have contributed to the ultimately adverse rulings by the Board. If the facts surrounding such a proceeding are to be fully explored and considered, I believe that a hearing such as would be required by S. 2721 is necessary. ASTA also believes that such proceedings should be specifically made subject to the protections afforded by the Administrative Procedure Act, and therefore endorses Section 601 of S. 2721.

In concluding, Mr. Chairman, I would like to thank you and the Members of this Committee for the opportunity to appear before the Committee today on behalf of ASTA, the travel agency industry, and small businessmen throughout the nation. Vigorous and ongoing efforts to create and maintain a healthy and vital economic environment are essential to the welfare of our small business

community. Your recognition of the unfortunate situation which has developed in the area of bank regulation is especially important at this time—not only within my own industry but in many other industries which have appeared and which will be appearing before this Committee.

We do not fear competition—we welcome it. But competition must be fair and evenhanded. For this reason, the Congress must act now to reassert its leadership, thus assuring that the tradition of separating banking from commerce—a tradition as old as this country itself—is maintained. This, in turn, will assure the public benefits which flow from a sound banking system and a free and competitive environment for our business community.

I hope that my comments will be helpful to you in the performance of your most difficult and important task.

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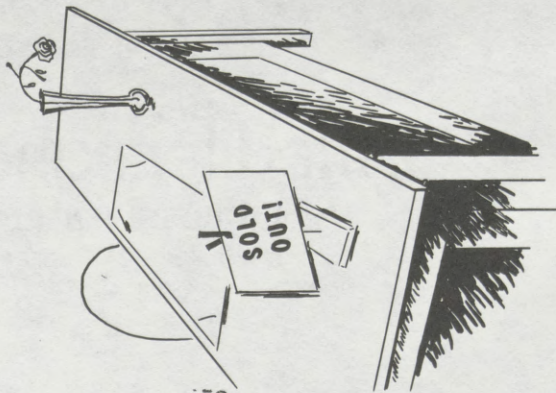
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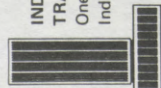
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The CHAIRMAN. Gentlemen, I see you all have long statements. I would appreciate it very much if you could abbreviate these as much as possible. Our next witness is Mr. Mallon. Mr. Mallon, you have a formidable statement. I presume a lot of this is appendices.

STATEMENT OF ROBERT P. MALLON, NATIONAL AUTO DEALERS ASSOCIATION, INC.; ACCOMPANIED BY PIERRE J. LA FORCE, SPECIAL LEGAL COUNSEL

Mr. MALLON. Thank you, Mr. Chairman.

Mr. CHAIRMAN, members of the committee, my name is Robert P. Mallon. I am appearing today as spokesman for the National Automobile Dealers Association. We have filed our written statement with the committee and I would like, at this point, to briefly summarize the principle points made therein.

First, by way of personal background, I would like to note that I am from Tacoma, Wash. where my family and I operate an automobile dealership and automobile leasing business. I pretend to no expertise on the more legalistic aspects of this legislation or of our comments therein. On that point, I will defer to Pierre J. LaForce, our special counsel who has been assisting us the last few years on the bank leasing controversy. I believe, however, that I am well qualified to testify about the day-to-day operation of the automobile retailing business and about the economic realities of that business.

NADA's interest in this legislation, and its purpose in being here today, is to acquaint the committee with the very serious problems resulting from the involvement of financial institutions, particularly bank holding companies, in the automobile leasing business. This is not a new issue for us. We have been on record since the mid-1960's in opposition to automobile leasing by financial institutions. First, it was with the Comptroller of the Currency with respect to national banks; now it is with the Federal Reserve Board, with respect to bank holding companies. Our most recent bout was with the Federal Reserve Board which, in March 1974, authorized bank holding companies to engage in automobile leasing activities. We had participated in the rulemaking hearings preceding that determination in opposition to such an authorization and we pursued the matter in the United States Court of Appeals for the District of Columbia Circuit. The result of that appeal was that, 2 weeks after oral argument and before the court had an opportunity to act on the appeal, the Board sought and obtained a remand of the case to the Board for further rulemaking proceedings. A hearing on these reopened proceedings has been scheduled for March 23 before the Board.

Automobile dealers have a very definite interest in passage of this legislation. We would add that the public interest would also be served by passage of this legislation. There is a very definite need for a clear restatement of the basic economic principle that the lines of banking and commerce should be divided. It is our position that the bank regulatory agencies have not followed the congressional intent in that respect and it appears to us to be necessary for the Congress to reinforce the guiding principle by substantive amendment of the Bank Holding Company Act.

The latitude intended by Congress in its passage of the Bank Holding Company Act of 1956 was a limited one. For the first 14 years, the Federal Reserve Board, for the most part, interpreted that statute in accordance with the congressional directive. Since 1971, however, the Board has discarded the necessary "strict construction" approach and has allowed bank holding companies to cross the line between banking and commerce. S. 2721 would curb that expansionistic tendency.

Our own experience before the Board on the issue of automobile leasing will serve as a graphic example of the need for this legislation. Again, it should be made clear that automobile leasing is a form of automobile merchandising, not a banking activity. An automobile lease is an alternative to an outright new car sale. The key element in an automobile leasing transaction, and to the leasing business in general, is the ability to project the resale value of the vehicle at the end of the lease and the ability to dispose of the vehicle at that price or more. These are not skills to be gained in the everyday operations of a bank; this expertise is obtained only in the more hurly-burly world of automobile merchandising. We made that point to the Federal Reserve Board in the rulemaking proceeding. We also introduced evidence at the Board on the manner in which bank holding companies were actually operating their automobile leasing businesses. We showed, for example, that bank holding companies were offering their lease customers discounts on tires, replacement parts and servicing; that bank holding companies were touting themselves as being expert in both the new and used car markets; that they were representing to the general public that they would take over the entire responsibility of "haggling" in the purchase of the leased vehicle and its later disposal. Each of these activities is a necessary incident to automobile merchandising and, concomitantly, each of these activities has absolutely nothing to do with banking.

Notwithstanding this showing, the Federal Reserve Board determined that bank holding companies could engage in automobile leasing if they conducted their operation in accordance with an elaborate regulatory formula which was deliberately fashioned to permit them to enter the automobile-leasing field. The Board held that leasing activities conducted under this formula constituted "the functional equivalent of an extension of credit" and was therefore, a financial, closely related activity.

That conclusion was contrary to the economic facts of life of the automobile leasing business. The Board ignored the essential mercantile nature of that business, evidenced most clearly by the importance of the resale value estimate and the ability to market at that estimate, and the other automobile merchandising incidents of that business which I have just mentioned. Frankly, we were, and are at a loss to understand how anyone could view a business activity involving the offering of tires, parts and automobile services at a discount, being intimately involved in the new and used car markets and professing to be experts therein, could be viewed as a banking-related activity.

It is not enough, in our view, to view an activity as banking related simply because there may be some element of credit involved. If that is to be the test, then there can be no dividing line between banking

and commerce, given the credit-oriented nature of today's society. It is only when an activity is basically and essentially a financial one that it should be permitted to bank holding companies. The bill under consideration today, with its requirement that the activity be directly related and that it be a necessary incident to banking, will redress some of the imbalance caused by recent interpretations and policies of bank regulatory agencies.

We are gratified to note that the legislation will require the Board to consider the long-term impact on competition of proposed bank holding companies expansion. This is a matter which we feel has received little, if any, attention by the Board. In the automobile leasing business, it is inevitable that bank holding company entry will result in a substantial loss of independent automobile lessors. This isn't just our economic forecast; it is a prediction which has been made by the banks themselves.

The most essential matter to true competition in the leasing field is an assurance of the availability of bank credit to automobile lessors. Bank credit is the essential commodity to independent automobile lessors; without bank credit, at a competitive rate, automobile lessors simply cannot do business. To the extent that bank holding companies and other financial institutions enter directly into the automobile leasing business, there is a corresponding decrease in the number of credit sources open and available to independent lessors. The inevitable result would be that the market will become dominated by a few banking institutions which will offer their own standardized lease programs. There will be fewer leasing alternatives available to the consuming public, to its detriment. As I mentioned earlier, true competition in this business can be assured only by the continued existence of an industry characterized by multiple, unrelated independent lessors, offering a variety of lease programs. Speaking for myself and NADA, we do not want to become part of a bank leasing programs, or to serve as agents of such a program. We want the opportunity to operate our own leasing businesses, to stand on our own feet, and to base our survival on the competitive viability of our leasing services.

To repeat, what is essential to a viable, competitive automobile leasing business is the ready availability of bank financing of lease operations. With wholesale bank holding company entry, there will be a drastic erosion of that credit source. This is an extremely credit-sensitive business, very susceptible to excesses and abuses and the eventual domination of the business by the credit source. If for no other reason than this, bank holding companies should be interdicted from entering into this business.

While I am on the issue of competition, I would like to put to rest once and for all the contention that banks and bank holding companies must get into the automobile leasing business to preserve their share of the automobile financing market. There will always be a ready, available market for bank credit in automobile retailing. Independent retailers such as myself will continue to rely extensively on bank credit, whether our merchandising takes the form of outright sales or of leasing. The banking institutions need have little fear that we are going to go away.

We noted in our written statement our full support of that provision of the bill which would bring some measure of uniformity in

bank regulation. I will restrict myself to saying here that it is both much and long overdue. Clearly, national banks should never, never have been permitted, as they have been by the Comptroller, to do what goes beyond the powers of bank holding companies. National banks are by definition and by specific statutory provision intended to be creatures of limited power. In fact, we would submit that a proper interpretation of the National Bank Act would preclude national banks from areas which would be permitted to bank holding companies under the more liberal provisions of the Bank Holding Company Act.

As a beneficial side effect of the uniformity provision of the legislation, we would hope to see an end to the kind of "ping-pong" decisional rationale of which we have been victims in our sparring with the Federal banking agencies. As pointed out more fully in our statement, when we objected at the Board level to bank holding company involvement in automobile leasing, we faced the argument that the Comptroller had already authorized it for national banks. When we argued in court against national bank involvement in this activity, the argument was made that the Board had recently authorized it for bank holding companies. Then, we argued in the Court of Appeals that the Board had erred in allowing bank holding companies to engage in automobile leasing, the Board argued that the Federal District Court in Seattle had recently approved this activity for national banks. The issues being decided by the Board under the Bank Holding Company Act are too important to receive such facile, short-shrift treatment.

NADA has just been through a judicial review proceeding of the Board's 1974 rulemaking decisions authorizing bank holding companies to engage in automobile leasing and, as I have noted earlier, we are now back before the Board on further rulemaking. We can attest from first-hand knowledge about the absolute need for the procedural reforms contained in S. 2721, which would assure basic due process protection in the Board's rulemaking proceedings. We have detailed the several procedural deficiencies in the Board's present system in our statement. I will not repeat them here but I would like to stress the point that the decisions being made by the Board in this area are too important, affect too many interests and are too pervasive to be made in secret proceedings, without a full ventilation of the issues. The only way we know to assure that adequate consideration be given is through adoption of the procedural reforms set forth in S. 2721.

I would like to conclude by informing the committee that the situation in the automobile leasing field is very serious now and that it is becoming more so. We fear, with a considerable amount of justification, that a large number of banking institutions, principally bank holding companies, are waiting to descend en masse on the automobile leasing business once they feel the air is clear. If that should happen, automobile retailers, at least the independent ones, are in for some very hard times.

We thank the committee for the opportunity to make this presentation and we will attempt to answer whatever questions the committee may have. Thank you.

[Complete statement of Mr. Mallon follows:]

HEARINGS
before the

COMMITTEE ON BANKING, CURRENCY AND
URBAN AFFAIRS
UNITED STATES SENATE

on
S. 2721

STATEMENT
of

ROBERT P. MALLON
on behalf of
NATIONAL AUTOMOBILE DEALERS ASSOCIATION

Mr. Chairman and Members of the Committee:

My name is Robert P. Mallon. I am a small businessman from Tacoma, Washington, where members of my family and I own and operate an automobile dealership, Mallon Motors, Inc., and an automobile leasing business, M & M Leasing Corp. I am presently serving as a member

of the Board of Directors of the National Automobile Dealers Association and as Washington State Director of that Association and I appear today as that Association's spokesman. Accompanying me is Mr. Pierre J. LaForce, who has been representing NADA on matters relating to the entry of financial institutions into the automobile retailing business.

The National Automobile Dealers Association ("NADA"), as the Committee knows, is a national trade association, representing almost 20,000 franchised new car and truck dealers engaged in selling and servicing new and used cars and trucks of all makes, domestic and imported, in the fifty states.

NADA is appearing today at the invitation of the Committee, to testify on matters respecting S. 2721, the Competition in Banking Act of 1975. The letter of the Chairman inviting us here requested that we focus our testimony on certain designated issues raised by S. 2721 and we have attempted to so structure our statement.

We believe that our less-than-happy experiences of the last few years with regard to the entry of financial institutions into our business will be both relevant and helpful to the Committee's consideration of this bill. Specifically, I believe that we are particularly well qualified to testify on the need for the procedural

reforms contained in S. 2721.

Before proceeding to a discussion of the issues listed in Chairman Proxmire's letter, we would like to make a few introductory comments concerning (1) our specific interest in passage of this legislation and (2) the overall public interest considerations which clearly support the bill.

NADA Involvement

In the last decade or so, the automobile merchandising business has experienced a pronounced and increasing interest in automobile leasing, as opposed to automobile purchasing. The merchandising nature of the automobile retail business has not changed, but a growing number of car users prefer to lease their automobiles rather than purchase them. As automobile dealers, our function remains the same. We are still engaged in the merchandising of automobiles; only the form of the transaction has changed somewhat.

Estimates vary widely as to what the ultimate share of the automobile merchandising market leasing will eventually assume, but it is safe to predict that automobile leasing will constitute a very substantial part of the total automobile merchandising market. Automobile dealers have recognized that automobile leasing is an integral

part of their business and a great many of them, including myself, have established leasing businesses to accomodate this new development in automobile merchandising.

As this Committee is well aware, in the mid 1960's, the Comptroller of the Currency determined to chart a radically new course of permissible business activities for national banks. In a series of unprecedented and unsupported "interpretive rulings" (most of which have since been invalidated by the courts), the Comptroller purported to authorize national banks to engage in a host of non-banking activities. One of the activities so authorized was the leasing of personal property, including automobiles. While some national banks quickly seized on this opportunity to branch into non-banking areas, the number of financial institutions engaged in automobile leasing remained relatively small until 1970. Since then, financial institutions, particularly bank holding companies, have entered the automobile leasing business in large numbers.

As a national trade association, NADA has been concerned over this issue since the Comptroller first announced that national banks would be permitted to engage in automobile leasing. NADA has expressed its concern, and the factual, legal and policy bases therefor, to the Comptroller and the Federal Reserve Board on several occasions, all to no avail. NADA's most recent experience

with the bank regulatory agencies came in September 1973 when it participated in a Federal Reserve Board rulemaking proceeding on the permissibility of leasing activities by bank holding companies. NADA was unsuccessful before the Board. NADA sought judicial review of the Board's action and, shortly after oral argument in that appeal, the Board, on its own motion, sought and obtained remand of the case to the Board for further rulemaking proceedings. As a result of this action, a hearing on the issue of automobile leasing by bank holding companies is scheduled to be held by the Board on March 23.^{1/}

NADA has also supported the efforts of certain Washington State automobile dealers, including myself, seeking to invalidate the ruling of the Comptroller that national banks can engage in automobile leasing. As the Committee may be aware, that effort was unsuccessful on the federal district court level, but we have appealed the decision to the United States Court of Appeals for the Ninth Circuit where we hope to secure a reversal.

^{1/} Attached as Appendix A is a copy of NADA's initial comments in the pending Board proceeding. These comments set forth, in part, NADA's position on the "bank leasing" issue.

Public Interest Considerations

It is a basic and salutary precept of American economic regulation that there should exist a clear, distinct demarcation between banking and commerce. The purpose of such a demarcation is obvious. It is to the ultimate public good that the suppliers of the nation's credit be interdicted from competing with the users of that credit. If it were otherwise, an inevitable concentration of economic resources in the hands of financial institutions would result.

Regrettably, and to the real detriment of the public good, the demarcation between banking and commerce has become increasingly blurred in recent years. Beginning with the radical interpretive techniques of the Comptroller of the Currency in the mid-1960's, the federal bank regulatory agencies have appeared to be willing participants in the efforts of certain banking interests to convert financial institutions into veritable department stores of non-financial services and activities. While Chairman Burns has characterized this lamentable development as a "competition in laxity", we would comment that the recent attitudes and pronouncements of the bank regulatory agencies reflect a much more serious maladjustment, namely, a value or policy determination that the line between banking and commerce should be eradicated.

We feel that the Congressional policy of maintaining the demarcation between banking and commerce has always been clear, but it is our opinion that the federal

bank regulatory agencies have not implemented that policy. Some regulators, most notably Chairman Burns, have recently expressed serious misgivings at this policy of administrative largesse. While we view this as an improvement in the regulatory climate, it seems clear that the dismal experience of the last few years of "go-go" bank mania, with its attendant speculations and involvements in non-banking activities, clearly supports a restatement by the Congress that banks and bank holding companies must be restricted to the banking field. S. 2721 represents such a declaration and we support it.

With this introductory statement I shall now proceed to a discussion of the issues listed in Chairman Proxmire's letter to us.

I

Necessity To Restrict Bank Holding Companies To Activities "Directly" Related To Banking

Section 301 of S. 2721 would amend Section 4(c) (8) of the Bank Holding Company Act, setting forth the standard for permissible non-banking activities of bank holding companies, by requiring that the activity in question be "directly" as well as "closely" related to banking and by further requiring that the activity be a "necessary", as well as "proper", incident to the

banking business. The effect of these additional requirements will be, in our view, to carry forward the long-established Congressional policy of restricting banking institutions, including bank holding companies to banking activities. For those businesses which have been the target of bank expansionism, such as the automobile retailing industry, amendment of the Bank Holding Company Act in this fashion cannot come too soon.

In the early days of the Board's administration of the Bank Holding Company Act, the Board properly took a very restricted view of what non-banking activities should be allowed for bank holding companies. However, the Board viewed the 1970 Amendments to the Act as carte blanche authority to permit wholesale entry of bank holding companies into clearly non-financial fields, including automobile leasing. Ruling after ruling of the Board reflected its regulatory view that a nominal, or even theoretical, relationship between the activities under consideration and banking was sufficient ground to permit bank holding companies to engage in the activity.

We saw a graphic example of this in the Board's handling of the automobile leasing issue. In that instance, the Board fabricated an elaborate regulatory formula under which bank holding companies could engage in automobile leasing. The Board theorized that leasing

under this formula constituted, in one of the Board's favorite phrases, "the functional equivalent of an extension of credit", and a proper activity for bank holding companies.

The principal difficulty with the Board's approach was that its theory simply did not comport with the economic fact of life in the automobile leasing/retailing business. Automobile leasing is essentially a mercantile, retailing activity and the manner in which that business is conducted reflects its commercial nature. The most important part of the automobile leasing business is the ability to project the resale value of the vehicle at the end of the lease term and the know-how and facilities with which to dispose of the vehicle at that projected price or more. That is the essence of the automobile lease transaction, not some theoretical notion of an extension of credit.

We pointed this fact out to the Board and documented it with a showing of how bank holding companies and other financial institutions were actually conducting their automobile leasing operations. We showed, for instance, that bank lessors were agreeing to provide for discount prices on tires, parts and services to their lease customers; that bank lessors were representing that, because of their size or because they had obtained a national fleet license, they could obtain automobiles at

a better price than could independent lessors and automobile dealers; that bank lessors represented that they were better automobile "shoppers" and that they would assume the entire responsibility for the purchasing and trading of vehicles for the lease customer. In short, with the possible exceptions of maintaining a service bay or display floor, bank holding companies in the automobile leasing business are involved in almost every facet of automobile merchandising.

A disinterested observer would surely have concluded that providing tires, replacement parts and repair services at a discount, dealing in new and used automobiles could hardly be characterized as a banking or banking-related activity. Certainly no such characterization can be made based on the presence of some "credit" element in the transaction. If the presence or absence of "credit" in a transaction is to be the determining point with respect to permitting bank holding companies to engage in an activity, we might just as well dispense with any test at all since, in this credit-oriented society, there is nary a business transaction which does not have some form of "credit" element involved.

We submit that the bank regulatory agencies, including the Federal Reserve Board, have improperly deviated from the course so clearly charted by Congress. There is a need to redress the imbalance created by this

unwarranted regulatory policy and we believe that S. 2721 represents a much-needed step in that direction.

II

Adverse Effects of Bank Holding Company Entry

Under the Bank Holding Company Act, in determining whether an activity is a permissible one for bank holding companies, the Board must find that the probable public benefits of bank holding company entry will outweigh the possible adverse effects. This statutory language was added by the 1970 Amendments to the Act and it is clear from the language itself (and clearer yet from the legislative history) that the probable public benefits must affirmatively outweigh the possible adverse effects in order to warrant a favorable determination by the Board. Yet, we found, in our recent appeal of the Board's personal property leasing rulemaking, that the Board, or at least the Board staff, has construed this "public benefits" test to require only a negative finding that adverse effects will not "likely result" from bank holding company entry. This is exactly the reverse of what Congress said and intended in the 1970 Amendments.

The amendment to Section 4(c)(8) of the Act by Section 301 of S. 2721 would correct this bit of

administrative legerdemain and, additionally, would require a much more definite showing of predominant public benefits to be derived from bank holding company entry than is the present case. This must be regarded as a definite plus for the public good since it is only fit and proper that the burden for demonstrating "clearly and significantly" that net public benefits will result from bank holding company entry should rest with the proponents of that entry.

Section 301 of S. 2721 would further amend the "public benefits" section of the Bank Holding Company Act by requiring that the Board consider the impact of bank holding company entry on competition over the long term, and not simply the immediate competitive effect of such entry. While the present law clearly suggests that both long-range and short-range effects of bank holding company entry are to be considered, it has been our observation that the Board has restricted its analysis to the short-term effect on competition. In fact, we would further observe that the Board, at least in the case of automobile leasing, has paid little heed to the anti-competitive impact of bank holding company entry. For example, we showed at the rulemaking hearing held by the Board in 1973 that bank representatives themselves were forecasting that wholesale entry of financial institutions in the automobile leasing business would produce a significant fatality rate among smaller automobile lessors. Recent

statements by banking representatives on file with the Board also reflect that view.

Ascertainment of the ultimate effect on competition is clearly necessary to a reasoned determination of whether a particular activity is one which should be authorized by the Board. Where, as in the case of automobile leasing, any increase in competition is transitory only, if at all, and the long-range effect will be a decrease in competition, bank holding company entry should most definitely not be allowed.

If bank holding companies continue to be permitted to engage in automobile leasing, it is inevitable that these institutions will soon assume the great share of the market, to the exclusion of independent lessors and automobile dealers. Clearly, the public interest will not be served if the automobile leasing market place is dominated by a few bank holding companies, with their own very standardized and limited lease programs. Instead, true competition in the automobile leasing business can be assured only through the continuing business existence of many, unrelated automobile lessors, offering a variety of lease programs to the public.

In a related vein, one issue which has received scant regulatory consideration from the Board is the degree to which a particular business activity is "credit-sensitive" and the impact this consideration should have on the regulatory determination of whether bank holding

companies should be permitted to engage in that activity. It would appear self-evident that the more credit-sensitive the industry, i.e., the more credit-reliant the businesses in that industry, the more susceptible that industry is to the possible anti-competitive effects of bank holding company entry.

We have an extremely credit-sensitive situation in the automobile leasing business. Automobile dealers-lessors such as myself are very much reliant on bank credit, and the availability thereof at a reasonable cost. Accordingly, it is of considerable concern to us that those institutions having a monopoly power and control over the essential commodity of credit now propose to engage in direct competition with us. We would submit that it is this very type of situation to which the long-established policy of restricting banks to banking activities is directed. The sources of credit supply should not be permitted to compete unfairly with the users of credit in the automobile leasing/retailing business, or any other credit-sensitive business for that matter.

As a final word on the issue of competition, we would like to address ourselves to the contention that bank holding companies should be permitted to engage in automobile leasing activities in order to preserve their automobile financing business. The short answer to this contention is that the automobile leasing phenomenon poses no threat whatsoever to the automobile

financing activities of financial institutions. Automobile dealers - lessors will continue to rely extensively on bank financing in their merchandising of automobiles, regardless of the form that this merchandising takes. If, as predicted by some, automobile leasing assumes a major part in new car sales, the financial needs of automobile lessors will likewise increase and there will be a very available, sometimes, avid, market for bank financing.

III

Uniformity of Regulation of Financial Institutions

Section 401 of the bill would provide a much-needed uniformity in bank regulation. That section would prohibit a national bank from engaging in (and, presumably, the Comptroller of the Currency from authorizing) an activity which the Federal Reserve Board had found to be an improper activity for bank holding companies. It is anomalous indeed that such a statutory prohibition should be necessary, but it clearly is, in view of the regulatory aberrations of the office of the Comptroller of the Currency.

It is incontrovertible that the Bank Holding Company Act provides a broader grant of powers to bank holding companies than does the National Bank Act for national banks. In fact, the principal raison d'etre for a bank holding company is to permit these institutions to engage in a broader scope of activities than would be

permissible under their national bank or state bank charters. Yet, in recent years, the Comptroller of the Currency has persisted in authorizing national banks to engage in activities which even the Board has viewed as improper for bank holding companies, all to the detriment and confusion of the banking industry, other affected businesses and the public interest alike.

Another beneficial effect of the prohibition contained in Section 401 of the bill would be the elimination of the "ping-pong" decisional rationale utilized by federal bank regulatory agencies. We in the automobile leasing business have been the victims of that technique. In 1973, when we appeared before the Federal Reserve Board and opposed the entry of bank holding companies into the automobile leasing business, we were confronted with the argument that this was a proper activity since national banks were permitted by the Comptroller to engage in that activity directly. Later, in our federal district court litigation in Seattle against the Comptroller, challenging the authority of national banks to engage in automobile leasing under the National Bank Act, the argument was raised that this was a perfectly proper activity for national banks since the Board had recently authorized it for bank holding companies. Still later, in our appeal of the Board's rulemaking determination to allow automobile leasing by bank holding companies, we faced the contention that the Court of Appeals should affirm the Board because the federal district court in

Seattle had ruled that the Comptroller's ruling that national banks could engage in automobile leasing was valid. This exercise in circuitry of reasoning deprives an affected party, such as the automobile dealers, of a meaningful, rational decision, based on the facts. Likewise, it constitutes at least a partial abdication of the decision-making responsibility delegated to the Board by the Congress.

IV

Need for Procedural Reforms in Section 4(c)(8) Rulemaking Proceedings

One of the most important aspects of S. 2721 is the proposed amendment of the Bank Holding Company Act to require that all section 4(c)(8) proceedings of the Board be conducted on the record, with rights of cross-examination, and otherwise subject to the formal rulemaking provisions of the Administrative Procedure Act. The need for this procedural reform cannot be over-emphasized.

To begin, section 4(c)(8) rulemaking proceedings are those in which the Federal Reserve Board determines the substantive question of whether a particular business activity is one in which bank holding companies should be allowed to engage. These proceedings are of vital interest to businesses engaged in the activity under consideration and possible new entrants therein, to the financial industry and, finally, to a reasoned implementation of the public policy separating banking and commerce.

The present procedure utilized by the Board is wholly inadequate to this task. At present, it is Board policy to handle these proceedings as informal rulemaking, with precious little in the way of procedural due process. The Board publishes a notice of proposed rulemaking, solicits written comments and generally schedules an oral hearing "before available members of the Board" (never more than two or three in number). There is no right of cross-examination, nor any opportunity to test the veracity, reliability or soundness of the materials submitted and, only when ordered by the Board, is there an opportunity to submit rebuttal statements. These proceedings are not conducted on the record and there is extensive ex parte communication between the Board staff, the Federal Reserve Banks and perhaps others, with the Board, all without notice to other interested parties or an opportunity to respond to the ex parte communications.

Of even greater repugnance is the Board's policy of refusing public disclosure of the nature and content of these ex parte communications. Finally, the informal rulemaking actions of the Board are subject only to a limited form of judicial review, a review which is further circumscribed by the Board's refusal to furnish the entire administrative record in judicial review proceedings.

Given this state of affairs, it is hardly surprising that there have occurred instances of abuse and denial of procedural and substantive rights. NADA is

in a particularly good position to comment on this matter, since it recently participated in a judicial review proceeding involving the Board's rulemaking action allowing bank holding companies to engage in automobile leasing.

When we first examined the administrative record which the Board certified to the Court of Appeals as being those materials which it considered in reaching its rulemaking decision, we were greatly surprised to find that there were large quantities of materials which had never been made part of the public file. We were also shocked to find that, for the most part, all of the substantive parts of these ex parte communications had been deleted ("whited-out") in the copy of the administrative record furnished by the Board to the Court of Appeals. The Board sought to justify this approach on the ground that this was not an "on the record" proceeding and that it was entitled to maintain the confidentiality of the ex parte submissions made by its staff and the Federal Reserve Banks. However, considerations of confidentiality and consistency did not prevent the Board from furnishing an ex parte communication which was generally supportive of the action it took.

There is something inherently wrong and unfair in a procedural system which permits an administrative agency to designate certain materials as part of the administrative record which it considered (and perhaps

relied on) and yet refuse to disclose these materials for purposes of judicial review. On the one hand, the agency is arguing that the administrative record designated by it supports its action and, on the other, it refuses to supply these materials for weighing and testing by a reviewing court and interested parties. Under such circumstances, it is impossible for either a reviewing court or an appealing party to know whether the deleted portions of the record support the action taken or are contrary thereto or inconsistent therewith. The reviewing court and an appealing party must take the case on the agency's word. Even more distressing is that an aggrieved party, such as was NADA in its recent appeal, finds itself in the unenviable position of having its agency adversary dictating what parts of the administrative record the reviewing court shall be permitted to see.^{2/}

^{2/} An example of the kind of abuse which results when procedural niceties are not observed was unearthed in our review of the Board's administrative record in the recent NADA appeal. Somehow or other, the substance of two staff recommendations to the Board escaped the censor's scissors. Briefly, these staff recommendations were to the effect that (a) certain recommended consumer protection provisions not be adopted by the Board for fear that such adoption would aid an appeal of the Board's action by NADA, and (b) that the Board act immediately, notwithstanding the controversy over automobile leasing, lest such delay "add fuel to NADA's fires". Hopefully, these recommendations were not representative of the other withheld portions of the administrative record.

Procedural looseness and irregularity of this sort would not be countenanced in a zoning commission hearing. Much less should it be permitted in the Federal Reserve Board's consideration of the proper boundaries for bank holding companies. The public policy issues involved and the impact of the Board's decisions in section 4(c)(8) proceedings are too serious and far-reaching to permit these decisions to be reached in anything other than an open public forum in which all interested parties have equal public access to the decision-maker, and where the decision must be based on substantial evidence on the record and subject to full judicial review. The great public policy issues subsumed in section 4(c)(8) determinations require no less. NADA fully and wholeheartedly supports the procedural reforms provided in S. 2721.

Conclusion

The principal substantive issue under consideration in these hearings is the proper role bank holding companies and other financial institutions should play in the Nation's economy and, ultimately, in American social life. Shall the Congress continue to insist that bank holding companies and banks restrict their activities to banking and banking-related businesses, or is there

merit to the claims of the advocates of bank holding company aggrandizement that the distinction between banking and commerce is obsolete? It seems to us that the Congress can only answer this question by ascertaining where the public interest lies. Is it better served by an economic system requiring a clear divider between the activities of the credit suppliers and those of the credit users, or is a fusion of banking and commercial entities desirable? The experience of the last few years, culminating in a number of serious bank failures and widespread reports of banks in difficulty, provides a clear, irrefutable answer. The principle of demarcation between banking and commerce has continuing validity and results in the greater public good. S. 2721 would further implement this principle and we support its enactment.

APPENDIX A

Before the

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

In the Matter of
Part 225, Regulation Y
Bank Holding Companies
Interest in Nonbanking Activities
Automobile Leasing

COMMENTS
OF
NATIONAL AUTOMOBILE DEALERS ASSOCIATION

The National Automobile Dealers Association ("NADA") herewith submits its comments on the question of whether automobile leasing should be a permissible activity for bank holding companies. These comments are being submitted pursuant to the Board's public notice of November 11, 1975, inviting comments on this issue.

The instant rulemaking proceeding is the outgrowth of NADA's appeal of the Board's rulemaking action of March, 1974, adopting the present personal property leasing rule. Following oral argument in that appeal, and before the Court of Appeals issued a decision thereon, the Board sua sponte requested the Court to remand the case to the Board for further rulemaking proceedings. Specifically, the Board requested remand "for the purpose of receiving public comment on the question whether automobile leasing should continue to be considered to be a permissible activity for bank holding

companies."^{1/}

I

"Residual Value" and "Guarantee" Factor.

While the principal emphasis in this proceeding should be on the general question of whether automobile leasing should be a permissible activity, it would be appropriate, at this point, to comment briefly on the "residual value" and the "guarantee" factors of the Board's personal property leasing rule inasmuch as these factors are specifically alluded to in the Board's November 11 public notice. Under the personal property leasing rule adopted by the Board in March, 1974, a "full pay-out" lease is one in which the lessor's investment (acquisition cost and financing cost) is totally recouped from certain designated sources, namely: (1) rentals, (2) tax benefits, (3) residual value of the leased property at term end (which factor is not to exceed twenty percent of acquisition cost), and (4) with respect to short-term leases, such amount not to exceed sixty percent of acquisition cost, as may be attributed to an unconditional guarantee by a lessee, independent third party or manufacturer.

^{1/} The Board made clear, in a subsequent filing with the Court of Appeals, that the Board intended to review the automobile leasing issue de novo, notwithstanding the Board's phrasing of the question presented.

a. "Residual Value" Factor. Literally reams of comments were filed on this issue in the rulemaking proceeding preceding the Board's 1974 rulemaking action. Under consideration in that proceeding was a proposed ten percent limitation on the residual value factor. The Board's purpose in proposing a limitation on the residual value factor appears to have been to prevent bank holding companies from speculating or gambling on residual value in order to meet the "full pay-out" requirement.^{2/}

It is not at all clear what motivated the Board to finally adopt a twenty percent limitation. A February 25, 1974 memorandum from the staff to the Board of Governors recommended retention of the proposed ten percent limitation. For some reason, nowhere articulated in the administrative record of the prior rulemaking proceeding, the Board determined to raise the residual value limitation to twenty percent. Under these circumstances, NADA and other interested parties are at a complete loss (and at a severe procedural disadvantage) to comment on the final regulatory position adopted by the Board since the basis and rationale for that action are nowhere expressed.

^{2/} This approach continues to be both commendable and appropriate at a time when the Board and other bank regulatory agencies are especially concerned with the capital adequacy of banks. The Board is very familiar with bank failures and threats of failure. The Board is also fully aware that the solvency of a bank subsidiary of a holding company is affected by the solvency of a nonbank subsidiary (e.g., leasing company), and the decisions of their common management. Certainly, "gambling" on residual values has no place in a banking organization.

The Board's adoption of the sixty percent "guarantee" factor greatly minimized the relevance and importance of a residual value limitation, at least with respect to motor vehicle leasing. Notwithstanding this fact, NADA hereby reiterates its support of the ten percent limitation originally proposed by the Board. As reported to the Board in the staff memorandum of February 25, 1974, a ten percent limitation on residual value would not result in a conflict with the tax law requirements for a "true" lease. Setting the limitation at this level also is consonant with the regulatory purpose to deter bank holding company "speculation" on residual value.

b. "Guarantee" Factor. On this issue, NADA is even more in the dark as to the Board's rationale for inclusion of this factor in the "full pay-out" formula. The "guarantee" factor was not part of the proposed rule which was the subject of the September, 1973 rulemaking hearing. There is accordingly precious little in the administrative record of the prior rulemaking proceeding to indicate the basis and purpose for inclusion of this factor in the regulatory formula or the justification therefor.

Insofar as the incomplete administrative record of the prior rulemaking shows, it appears that the "guarantee" factor was first proposed by the Board's staff in its February 25, 1974 memorandum to the Board. In that memorandum, the staff recommended "that the Board adopt the regulation as proposed with a modification permitting a bank

holding company lessor to include in the full pay-out recovery formula an amount unconditionally guaranteed by a lessee, manufacturer or independent third party...."

It further appears from that memorandum that the staff proposal was intended to "permit bank holding companies to engage in open end vehicle leasing." Beyond this, the administrative record becomes even murkier. The staff recommended an unlimited "guarantee" factor for leases of five years' duration or less. The Board, without any record explanation whatsoever, adopted a "guarantee" factor limited to sixty percent of acquisition cost for leases of seven years' duration or less.

There is nowhere to be found any explanation for the Board's modification of the staff proposal, why it selected the seven years limitation or how it finally decided upon the limitation of sixty percent of acquisition cost. Truly, in these circumstances, NADA is seriously disadvantaged, to its prejudice, to comment meaningfully on the Board's action since there is absolutely no indication of the rationale for the Board's action. The only thing than can safely be concluded from the record is that the Board adopted the "guarantee" factor for the purpose of permitting bank holding companies to engage in automobile leasing. Beyond that, NADA can only surmise what the Board's rationale was.

The administrative logic for adoption of the "guarantee" factor seems to lie in the assumption that the "guarantee" factor makes the automobile leasing transaction "the functional equivalent of an extension of credit."^{3/} The actualities of the automobile leasing business demonstrate, however, that, in fact, a lessee guarantee of residual value does not have the effect of identifying an automobile lease as a financial activity.

A lessee guarantee can only have substantive meaning in the Board's determination on the automobile leasing issue if, in fact, the guarantee has economic significance in that the lessor is relying on this guarantee for a return of its profit. The facts of the automobile business are to the contrary; it is quite clear that, in this business, the automobile lessor is looking to the residual value (and its ability to properly predict same), not any lessor guarantee, for a successful transaction. As a matter of business practice, the setting of a realistic residual value is essential to a successful automobile leasing operation. Any automobile leasing operation which, in practice, relies to any material extent on the guarantee of the lessee will not long survive. The optimum situation for an automobile lessor is one where it never has need to look to the lessee's guarantee. The role

^{3/} This certainly seems to have been the position of the Board staff. See Staff Memorandum of February 25, 1974, p. 8.

of the lessee guarantee in a motor vehicle leasing transaction is thus an insubstantial one that cannot provide the basis for characterization of these leasing transactions as financial activities.^{4/}

The economic realities are that, even in an "open-end" lease, residual value is the crucial factor, not the creditworthiness of the lessee. Admittedly, the lessee guarantee is of some economic substance but it plays a very secondary role in the automobile leasing transaction, certainly not one of such substantiality as to warrant characterization of automobile leasing as "the functional equivalent of an extension of credit." Whatever merits the "guarantee" factor may have with respect to other forms of personal property leasing, it has no substantial applicability to automobile leasing, given the predominant role of the residual value projection in the automobile leasing transaction.

Of relevance to the "guarantee" factor issue also are the various state statutes limiting the amount of residual value liability that may be imposed on a lessee and the pending federal legislation on this matter, namely, the Consumer Leasing Act of 1975. The Board is aware that certain states have laws limiting the amount of residual value

^{4/} The fact that, in practice, an automobile lessor is really looking to residual value, rather than any lessee guarantee was implicitly recognized in the staff memorandum of February 25, 1974. See p. 8 thereof.

liability in "open-end" leases. Such legislation, of course, has direct relevance and impact on the Board's "full pay-out" concept since, in those states, no lessee guarantee can be "unconditional."

Additionally, there is presently pending before the Congress the Consumer Leasing Act of 1975, legislation which could directly affect the role the "guarantee" factor plays in the Board's "full pay-out" formula. The House version of that legislation sets a limitation on the residual value liability of the consumer lessee of three times the average monthly lease payment. Should this version of the bill be enacted into law, it will have the effect of prohibiting an "unconditional" lessee guarantee in the field of consumer leasing. Quite obviously, the aforementioned state laws and the pending federal legislation require the Board to re-evaluate the "guarantee" factor. It would seem clear that, if the Board is to fully honor its "full pay-out" concept of leasing, the "guarantee" factor must be deleted from the regulatory formula, at least with respect to consumer leasing.

As demonstrated above, a lessee guarantee has no substantive economic meaning or weight in automobile leasing. The Board should not permit bank holding companies to rely on this subterfuge as a basis for entry into the commercial activity of automobile leasing.

II

Automobile Leasing Is Not a "Closely Related" Activity.

The central issue before the Board in this proceeding is whether automobile leasing is a permissible activity under Section 4(c)(8) of the Bank Holding Company Act. It is NADA's position that automobile leasing meets neither the "closely related" standard nor the "public benefits" test of Section 4(c)(8).^{5/}

NADA has consistently maintained, before both the Board and the Court of Appeals, that automobile leasing is a discrete business activity substantively different from "big-ticket" leasing. It does not appear that the Board focused fully on this issue in its prior regulatory action. Instead, it seems that the Board devoted almost all its attention to adoption of a "full pay-out" formula designed to permit bank holding performance of this activity. Insofar as the prior administrative record shows, there was no real, in-depth examination of whether automobile leasing, as actually conducted, could be classified as a financial activity. Rather, it appears to have been the Board's rationale that, if automobile leasing could be conducted

^{5/} Rather than repeat arguments already made, appended hereto as Attachments 1-4 are (1) NADA's original comments in the September, 1973 rulemaking; (2) its supplementary comments therein; (3) its principal brief in the Court of Appeals; and (4) its reply brief.

under the same "rules" as "big-ticket" leasing, it should be permitted. In doing so, however, the Board did not analyze the significance, or lack thereof, of its "full pay-out" formula to automobile leasing, nor did it fully consider or analyze the nature of automobile leasing as contrasted with other forms of leasing.

NADA has already demonstrated in the preceding section that the lessee guarantee is of relatively minor significance, as a matter of business reality, in the automobile leasing business. In this section, NADA will show that the other essential facets of the automobile leasing business compel a classification of this activity as commercial, rather than financial.

To begin, it is abundantly clear that an automobile lessor is directly and substantially involved in the buying and selling of automobiles. Because of the importance of the residual value factor in the automobile leasing equation, an automobile lessor is also substantially involved in the non-financial activity of predicting the resale value of a motor vehicle at term end. No such involvement in merchandising is to be found in the business leasing of jet aircraft or tankers, for example.

The lessor of "big-ticket" items does not purport to be, nor does it need to be, an expert in the buying and selling of the leased equipment. An equipment lessor of

that type does not represent that it is capable of obtaining the leased equipment at bargain prices, prices which the lessee could not obtain on his own, nor does such a lessor represent that it has the facility and expertise to dispose of the equipment at term end in a manner more advantageous than the lessee. An equipment lessor is not so involved because what it is providing is a financial service in a financial transaction which is truly "the functional equivalent of an extension of credit." In this permissible area of financial leasing, it is the lessee - the airline, the shipping company, the computer user - which possesses the greater expertise and knowledge concerning the value of the leased property, where it may be most advantageously purchased and where it may be most effectively disposed. The role of the lessor in such a transaction is restricted to the furnishing of the necessary capital.

The automobile leasing business, as actually conducted, presents a wholly different factual format. In this business, residual value plays an integral, indeed, predominant, part in the transaction. Realization of the projected residual value is essential to a successful automobile leasing business. Essential as well is a knowledgeable, effective system of merchandising automobiles at term end. Also, competitive considerations require an automobile lessor to at least represent that it is capable of obtaining automobiles at bargain prices. Given these economic facts of

life, it can hardly be gainsaid that an automobile lessor is directly and necessarily involved in the merchandising of automobiles, on the new car and used car levels.

Perhaps the most cogent documentation of the essentially commercial nature of automobile leasing, as presently being conducted by financial institutions, can be found in a review of exactly how these institutions are conducting their leasing operations. Appended hereto as Attachment 5 is a representative sample of advertising and promotional materials now being used by financial institutions in connection with their automobile leasing operations. In addition to directing the Board's close attention and review of this Attachment, set forth below are excerpts from these promotional materials which, more eloquently than anything else, demonstrate the non-financial nature of automobile leasing:^{6/}

1. Maryland National Bank - (a) "As Maryland's largest bank, we do business with numerous car dealers and are probably in a better position to get the car of your choice than you are.";
- (b) "As a quantity buyer, we can often get your car for less than you could as an individual buyer.";

^{6/} Even more blatantly commercial is the content of mass media advertising, consisting of statements such as "We're the state's Number 1 car dealer," "We're in the automobile business now," and the like.

- (c) "You no longer have to get involved in car buying and trading. With an MNB lease, we take care of all that.";
 - (d) "When your car needs new tires, you can benefit from our tire discount rates.";
 - (e) "Should any serious problems arise with your car during the lease period, just let us know. We can act as an intermediary between you and the dealer.";
 - (f) "Our people are trained to advise you on options on equipment that will most benefit you at resale time.";
 - (g) "We will take care of registration and the periodic handling of new license tags."
2. National Bank of Atlanta (Atlanta Leasing Center) - (a) "You can drive a top line car for a reasonable price, or the car you are driving now for probably less than you are paying now. We buy at fleet prices. You can't.";
- (b) "You can customize your car - make, model, color, options, extras - and not have to shop for them. We will.";
 - (c) "Leasing...avoids the haggling of trading and buying again....";
 - (d) "We're staffed with leasing professionals who know the business. It's their only business.";
 - (e) "Since we're a major leasor, we get the best fleet prices. And charge in line with those prices.";
 - (f) "Since we buy in bulk, we get good service. (Being part of the First National Bank of Atlanta doesn't hurt either.)"
3. Town & Country Bank - (a) "We spend all of our time buying, selling and trading our units advantageously.";
- (b) "We are recognized as a National Fleet by the Vehicle Manufacturers. This entitles

us to many discounts which are passed on to you. Our accounts are issued National Fleet Cards which allow a 25% discount on repair parts throughout the country."

4. National Newark & Essex Bank - (a) "We buy in volume, so chances are we can get a better price on the car you want than you can.";
 (b) "All you do is tell us what car you want - and how you want it equipped. We'll let you know the exact monthly payment, and we can give you immediate delivery on most models.";
 (c) "At the end of your lease, you can choose to buy the car or sell it privately, or let us handle all the details of selling it for you."
5. Fulton Bank - "You no longer have to get involved in car buying and trading. With a Fulton lease, we take care of all that. The Latest Models With More Extras."

Another example of bank leasing advertising which graphically illustrates the merchandising nature of that activity was read into the trial record in M & M Leasing Corp. v. Seattle First Nat'l Bank. That advertisement stated, in part, as follows:

"Take a car, any car, be it from Detroit or Dusseldorf, Ford or Ferrari, just tell us what you want, what color, what options, we will shop around, find it, buy it, and deliver it to you personally. You will be spared all the wheeling and dealing that goes along with buying and trading, and since we are backed by the resources of the First National Bank and have the power of buying at fleet prices, we can get better deals and a bigger variety of cars.

Right off the bat you are ahead of the game, and when your lease is up, give the car up, and we will take care of selling it and save you from a tour of duty in the used car business.

....

No loan to tie you up. Right now money is one

of the most expensive things you can buy, and since there is no loan involved in leasing, you don't have to get involved in borrowing.... (Tr. 439-40.)

During the trial in the M & M Leasing Corp. case, the Deputy Comptroller of the Currency, Robert A. Mullin, when asked to comment on this advertising, testified as follows:

Well, this ad would make it appear that the bank was more of a marketer of automobiles than simply a lender of funds. (Tr. 1091.) ^{7/}

Mention of the M & M Leasing Corp. case immediately raises the issue of what impact that decision should have on the issue before the Board. In that case, the federal district court held that "open-end" automobile leasing was within the "incidental and necessary" powers of national banks under the National Bank Act. Indisputably, that decision is relevant. But it is neither dispositive nor is it good law. ^{8/}

First, it is absolutely essential that the Board analyze this issue on its economic, factual, legal and

^{7/} This was fully consonant with the Deputy Comptroller's earlier testimony that the primary business of banks was financial:

The banks are in the business of lending money, they are not in the business of selling real estate, automobiles, equipment, etc. (Tr. 1072.)

^{8/} That decision is presently on appeal in the Court of Appeals for the Ninth Circuit.

policy merits, rather than by simple reference to some district court precedent. There has been far too much of this sort of "ping-pong" decisional rationale. For example, when the automobile leasing issue first came before the Board, the proponents of bank holding company expansionism relied in major part on the interpretive ruling of the Comptroller of the Currency authorizing national banks to engage in personal property leasing. When the Comptroller's ruling was challenged in the M & M Leasing Corp. case, the defendant banks and the Comptroller relied, as precedent, on the Board's rulemaking action of March, 1974.^{9/} When the validity of the Board's personal property leasing rule was litigated before the Court of Appeals, it was urged that the M & M Leasing Corp. case was dispositive of the matters before the Court of Appeals. Surely, the time is well overdue for a fresh, hard look at this issue.

Second, it is clear that the court in the M & M Leasing Corp. case did not focus on the operational characteristics of the automobile leasing business, as actually conducted, or the impact these characteristics had on a proper classification of the automobile leasing business. No mention is made in that opinion of the several merchandising facets of the

^{9/} While it is difficult to determine what weight was accorded to the Board's leasing rule as a precedent by the district court, it is noteworthy that reference was made to this rule in the court's opinion.

automobile leasing business, factors which, on their face, illustrate that automobile leasing is far different from lending or even "big-ticket" leasing. Instead, the court relied in that case, in substantial part, on opinion testimony that "open-end" leasing constituted the functional equivalent of an extension of credit. NADA submits that this approach was far too circumscribed, particularly in the absence of any meaningful analysis of how the automobile leasing business is actually conducted and what functions the typical automobile lessor performs.

It is not sufficient, for purposes of the "closely-related" test of the Bank Holding Company Act (or the National Bank Act, for that matter), to restrict the regulatory analysis to a consideration of whether or not an element of "credit" is present. The fact that a transaction may smack of an extension of credit is of little assistance in determining the ultimate question of whether or not the activity in question is financial in nature.^{10/} In today's credit-dominated society, most businesses engage in transactions in which "credit" is extended, but surely even the most zealous bank holding company proponents would not argue that this makes all such

^{10/}

If all that needs be shown for Section 4(c)(8) authorization is the presence of a "credit" element, the list of permissible activities will be a long one indeed. For example, why not a "credit" mail order house? The bank holding companies would be acquiring property only on the specific order of the customer and they would be extending "credit" for purchase of the item.

transactions "financial" and thus permissible for bank holding companies. What is required is an in-depth assessment of the operational characteristics of the activity to determine whether, in fact and in operation, that activity is financial or commercial in nature. When that test is applied to the automobile leasing business, it must be concluded, based on the facts and not on abstract economic theory, automobile leasing does not meet the "closely-related" test of Section 4(c)(8) of the Act.

One final matter should also be considered by the Board on the "closely-related" issue. During the legislative hearings preceding enactment of the 1970 Amendments to the Act, two Chairmen of the Board testified in favor of permitting bank holding companies to engage in limited leasing activities. Former Chairman Martin testified in favor of permitting leasing activities "where the payment of rentals ...will reimburse the lessor for the full purchase price of the equipment." Chairman Burns favored bank holding company leasing "where the lease is really a form of security for financing."^{11/}

Automobile leasing does not meet either of the

^{11/} It is significant also that both Chairman Martin and Chairman Burns referred to the leasing of business equipment. Similarly, the congressional testimony of the ABA lobbyist also confirmed that it was business leasing for which authority was sought.

foregoing standards. As noted already, residual value plays a predominant role in the automobile leasing transaction, with that value ranging from 35% to 55% of cost. This kind of lease transaction can hardly be viewed as one where the lessor's cost is to be reimbursed through rentals (former Chairman Martin's test) or where the lease is merely a form of security for financing (Chairman Burns' test). To the contrary, the typical automobile lease represents a commercial transaction where a major reimbursement factor is the value of the leased item at term end. The automobile lease is not a form of security for financing; it is instead the transactional form by which an automobile merchandising activity is conducted. The automobile lessor is not looking to the lease as "security," nor does it anticipate to recoup its investment from "the payment of rentals"; instead, the automobile lessor is speculating that its estimate of residual value is a correct one and that resale of the leased vehicle will make it whole and provide a profit. This form of business activity is far removed from what the Board urged the Congress was permissible leasing, and it is not an appropriate or permissible activity for bank holding companies.

III

Automobile Leasing Does Not Meet the "Public Benefits" Test of the Statute.

In order that an activity may be deemed permissible for bank holding companies under Section 4(c)(8) of the Act,

the activity must not only be "closely related," but it must also be found by the Board that the probable public benefits of bank holding company entry will affirmatively outweigh the possible adverse effects of such entry.^{12/} The Board has taken the position in judicial proceedings and elsewhere that no final determination on the "public benefits" test is reached by the Board in rulemaking proceedings and that that test can only be finally applied with respect to specific bank holding company applications. Nevertheless, the Board has also indicated that it can and does apply the "Public benefits" test, on a generic basis, in considering whether or not a particular activity should be permitted.^{13/}

Given the unique role of banks as the principal suppliers of credit to American business, it would appear self-evident that the Board, in applying the "public benefits" test, even generically, should be particularly sensitive to those activities where capital and credit needs are intensive. The more credit-sensitive the business activity, the more exacting should be the Board's application of the

^{12/} The test is not, as articulated in the staff memorandum of February 25, 1974, whether performance of the activity by the bank holding companies would "likely result" in adverse consequences.

^{13/} In fact, the Board has held in rulemaking proceedings, as in the case of mortgage guaranty insurance, that "public benefits" considerations militated against a grant of authority.

"Public benefits" test. Automobile leasing is an instance requiring the most rigorous sort of "public benefits" evaluation. Automobile merchandisers, be they sellers or lessors, are heavily dependent upon bank credit and are, accordingly, highly vulnerable to bank involvement in the automobile merchandising activity.

It is an acknowledged economic fact that banks are in the position to exert a squeeze on equipment lessors generally, and this is particularly true of automobile lessors. The concerns of automobile lessors about bank holding company entry are several, not the least of which is a very real apprehension about being in direct competition with the sources of credit supply. The always-present economic vulnerability of automobile lessors makes them very prominent targets for predatory activities.

NADA is also seriously concerned, as should be the Board, about the projections of bank economic forecasters that bank holding company entry into the automobile leasing business will produce "a high mortality rate among smaller independent leasing concerns." Wall Street Journal, July 5, 1973, p. 1. While it has been argued that bank holding company leasing by the "indirect leasing" method^{14/} would permit

^{14/} "Indirect leasing" is the method by which, pursuant to a master agreement between the financial institution and automobile dealers, automobile leases are generated. In this operational mode, initial customer contact is made through the automobile dealer.

"smaller" dealers to engage in leasing, the fact is that the decided trend is for bank holding companies and other financial institutions to engage in "direct leasing," where there is no dealer involvement. In any event, this argument is wholly specious. First, one would be hard put to identify a business activity which is more fiercely competitive than the automobile merchandising business. Second, it stretches credulity to the breaking point to posit that bank holding company entry will spur competition. It can be speculated that bank holding companies might "encourage" participation of the so-called "smaller" automobile dealers in the automobile leasing field. But, given the inequality of economic strength between the two, it is likely and probable, if not inevitable, that the participation of the "smaller" automobile dealers in the leasing business will be at the sufferance of the bank holding companies. This can hardly be viewed as an increase in competition, particularly if bank holding company entry will result in the elimination of truly independent automobile lessors. What is pro-competitive in this market is not a chain of bank holding company economic vassals, but instead, the preservation of multiple independent automobile lessors.

NADA has already demonstrated that residual value, and an accurate projection of same, play the major part in the success of an automobile leasing business. Notwithstanding all the rhetoric about lessee guarantees and reliance on

the creditworthiness of the lessee, the fact is that the typical automobile lessor is relying, in major part, on its ability to predict what the resale value of the leased automobile will be at term end. To the extent that the lessor is over-optimistic, it must bear the loss in "close-end" leases. In those states which have adopted statutory limitations on a lessee's residual value liability, the automobile lessor is also susceptible to economic loss in "open-end" leases. Should the Congress enact similar legislation, the same susceptibility to economic loss would be applicable on a nationwide basis.

Several of the Board's recent public pronouncements have emphasized the need for capital adequacy and for protection of banking assets. There is no question that an authorization of automobile leasing activities would have a negative impact on this valid regulatory concern. In the Board staff memorandum of February 25, 1974, the staff recognized that there was risk to the bank holding company automobile lessor even in open-end lease situations where there was an over-optimistic projection of residual value. The staff stated, however, that it did not believe "there is any accurate method to predict or quantify the degree of risk involved in bank holding company lessors' estimate of a vehicle's resale value." That kind of non-conclusion or non-finding simply will not do. The fact of the matter is that there is a real, measurable risk of loss, even in "open-end" leases, a risk

which will be substantially accentuated should national legislation be enacted limiting a lessee's residual value liability.

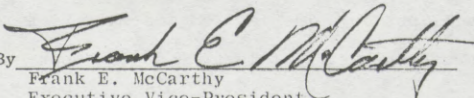
Finally, a review of all the facts relating to the automobile leasing business prompts the query whether or not this is an activity which bank holding companies should be authorized to enter. Is a business activity which is predominantly commercial and mercantile in nature, requiring specialized, non-banking experience and expertise, fraught with definite possible adverse effects on competition, the consumer and the bank holding companies, one to which the Board should affix its regulatory imprimatur. The answer must be clearly "no," for "public benefits" reasons alone.

CONCLUSION

NADA strenuously urges the Board to investigate and analyze what is really involved in automobile leasing. NADA submits that such an inquiry will convince the Board of the correctness of NADA's position and lead it to conclude, as is fully warranted by the facts, the law and applicable policy considerations, that bank holding companies should not be authorized to enter the automobile leasing business.

Respectfully submitted,

NATIONAL AUTOMOBILE DEALERS ASSOCIATION

By 
Frank E. McCarthy
Executive Vice-President

National Newark & Essex introduces car leasing

(and we're the first bank in New Jersey to offer you this service).

Leasing a car from us can let you avoid all the inconveniences of buying a car. And it will most likely save you some money.

1. **No Down Payment or Security Deposit.** You don't have to tie up capital when you lease a car from us. That means you can put that money in one of our savings account plans, or use it for some other investment.
2. **Low Monthly Payments.** Monthly payments are often lower than borrowing to buy a car. Why? Because the principal payments are based on the difference between the purchase price and the estimated resale value of the car, not on the full purchase price.
3. **Lowest Possible Purchase Price.** We buy in volume, so chances are we can get a better price on the car you want than you can.
4. **Low Bank Rates.** Financing—that's our business. So you know you'll get low bank rates. In addition, there's no middleman. Our people are bankers, not car salesmen. So there are no salesman's commissions to add on costs.
5. **Possible Tax Advantage.** Professional and business people who use a car in their work get this extra benefit. Check with your tax consultant to see what your tax deduction could be.

6. **No Inconvenience.** All you do is tell us what car you want—and how you want it equipped. We'll let you know the exact monthly payment, and we can give you immediate delivery on most models.

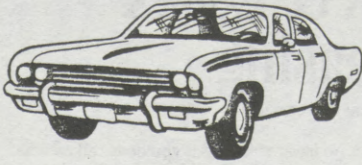
7. **Lease Any Car.** Unlike other leasing plans, you can lease the car you want. Our people have no axe to grind. Pinto or Porsche. Mercedes or Mercury. You name it. There's no mileage limitation, either.

8. **Three Leasing Plans.** You can lease a car from us for 12, 24, or 36 months. Which ever best suits your needs.

9. **End of Lease Options.** At the end of your lease, you can choose to buy the car or sell it privately, or let us handle all the details of selling it for you. If the amount you sell it for is more than our estimated resale value, you pocket the difference.

10. **Maintenance Protection.** Your car comes under all standard new car warranty and guarantee programs.

We don't know of a nicer way for you to get a new car when you want it. That's why we've added car leasing to the many personal services we offer you. It's just one more way we can show you that we're your size bank.



Yes,
we
lease
cars.

- All makes and models
- Small trucks, too
- 24- or 36-month plans
- Excellent monthly terms

Just let us know the car you want. We handle everything else for you!

Fulton Bank

Member F.D.I.C.

**New Car Time?
Think About Leasing!**

Many individuals, as well as companies, now lease at a substantial savings. And Fulton is one of the few banks in the country offering car leasing.

WHY LEASE WITH FULTON BANK:

Our economical lease arrangements will surprise you. Dealing with Fulton Bank, all questions will be answered clearly, expertly, and honestly. After all, we're a bank! You tell us exactly what you want. We buy the car and you lease it from us for 24 or 36 months.

**ADVANTAGES OF A FULTON
CAR LEASE:**

LOW MONTHLY PAYMENTS.

NO DOWN PAYMENT—A Fulton lease leaves your working capital free for placement in other income producing investments and savings.

CONVENIENCE—You no longer have to get involved in car buying and trading. With a Fulton lease, we take care of all that. Latest Models With More Extras.

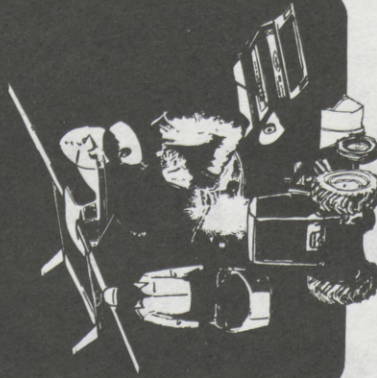
TAX ADVANTAGES.

EXTRA MONEY.

IMPROVES YOUR CREDIT.

For detailed information on the car of your choice, fill out and mail the attached postage paid business reply card.

Leasing



**town &
country
bank**

**town &
country
bank**

TOWN & COUNTRY CENTER TOWN & COUNTRY PLAZA
1000 N. 10TH AVE. SUITE 1000
HOME OF TOWN & COUNTRY/24 PHONE 787-3100
MEMBER F.D.I.C.

IT'S NO SECRET
Leasing is
Better Business

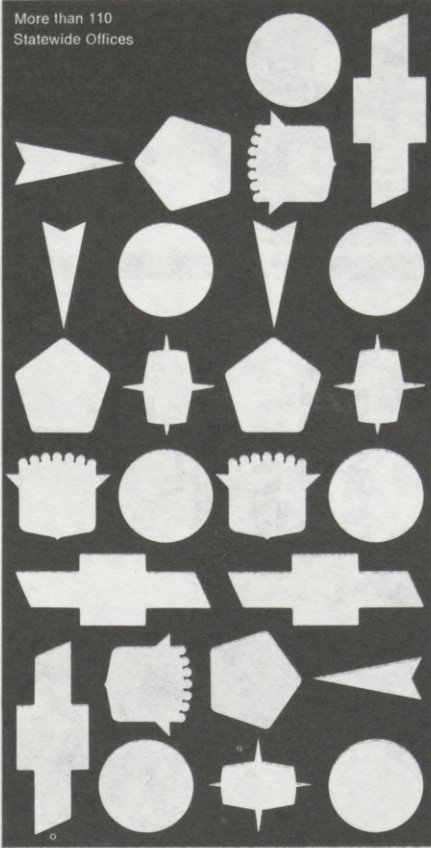




**maryland
national bank**

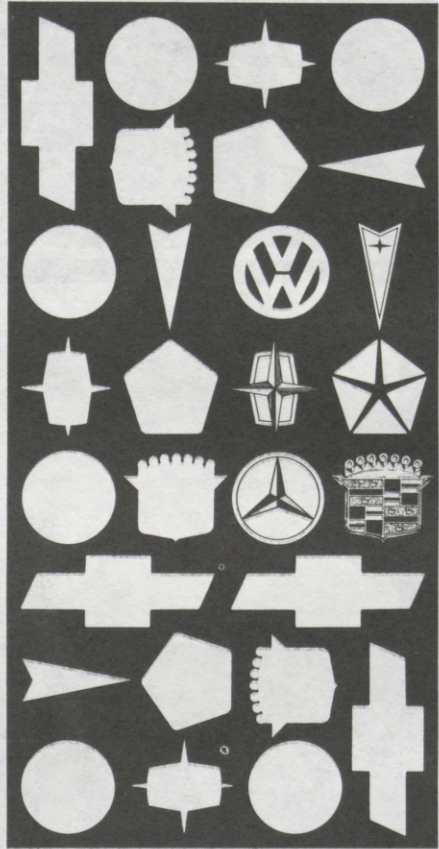
Member Federal Deposit Insurance Corporation

More than 110
Statewide Offices



**Car
Leasing**

maryland national bank



New Car Time?

Think About Leasing!

Many individuals, as well as companies, now lease at a substantial savings. About 14% of all new cars on the road today are leased, one-fourth of them to individuals.

We're one of the few banks in the country offering Car Leasing. As Maryland's largest bank, we do business with numerous car dealers and are probably in a better position to get the car of your choice than you are.

IT WORKS LIKE THIS:

You tell us exactly what you want. We buy the car and you lease it from us for 24 or 36 months. Your leased vehicle carries with it a new car warranty and the dealer from whom we purchased the car will provide you with courteous service treatment. At the end of the lease period, you return the car and we sell it. You can then lease a new model. It works the same for a fleet of cars.

ADVANTAGES OF AN MNB CAR LEASE:

Low Monthly Payments—Our lease payments are usually lower than if you finance a new car. They're based on the difference between the purchase price and the estimated resale value, plus the lessor's profit . . . not on the purchase price alone. As a quantity buyer, we can often get your car for less than you could as an individual buyer.

No Down Payment—Leasing requires no investment. An MNB lease leaves your working capital free for placement in other income producing investments and savings.

Convenience—You no longer have to get involved in car buying and trading. With an MNB lease, we take care of all that. Most cars can be picked up from the dealer within 24 hours after your request is approved. If necessary, we can arrange to have the car delivered to your address at a very nominal fee.

Latest Models With More Extras—90% of all leased cars are now equipped with power steering, air conditioning, automatic transmission and V8 engines. These "extras" are to your advantage, as they greatly enhance the resale value.

Tire Discounts—When your car needs new tires, you can benefit from our tire discount rates.

maryland national bank

LEASING APPLICATION

MAKE/MODEL OF CAR		OPTIONAL EQUIPMENT (LIST BELOW)	
NAME		ADDRESS	
AGE	PHONE NUMBER	SPOUSE'S NAME	EMPLOYER
BUSINESS ADDRESS		BUSINESS PHONE	NAME OF BANK

MAIN LEASING DEPARTMENT

P.O. Box 535,
Baltimore, Maryland 21203 962-5300

REGIONAL LEASING OFFICES

1713 West Street,
Annapolis, Maryland 21401 268-7681

705 East Charles Street,
La Plata, Maryland 20646 934-2281

125 Bay Street,
Easton, Maryland 21601 822-3500

8400 Baltimore Boulevard,
College Park, Maryland 20740 345-6400

P.O. Box 2318,
Salisbury, Maryland 21701 749-1561

82 West Washington Street,
Hagerstown, Maryland 21740 739-7100

Fill out the application attached and bring or mail it to the leasing office nearest you.

Tax Advantages — Businesses and individuals in certain professions may sometimes enjoy a 100% tax deduction for qualified lease expenses. Check with a tax consultant to find out what these advantages are and whether you can benefit.

Extra Money — At the end of the lease period, if you help sell the car and it brings more than the amount estimated in the lease, the amount over is money in your pocket.

Personal Contact — Should any serious problems arise with your car during the lease period, just let us know. We can act as an intermediary between you and the dealer.

Expert Assistance — Our people are trained to advise you on options and equipment that will most benefit you at resale time.

Improves Your Credit — An MNB car lease establishes a relationship between you and the State's largest bank. This continuing, paid as agreed arrangement improves your credit and enables us to process any future financial needs more quickly.

REQUIREMENTS FOR AN MNB CAR LEASE:

Insurance — You are probably already carrying the required coverage for an MNB car lease. If not, your insurance agent can bind you with it. The required coverage is: personal liability—\$100,000 each accident, \$300,000 each occurrence; collision—\$100 deductible or less; property damage—\$25,000; and full comprehensive. Maryland National Bank is to be named as Loss Payee and coinsured.

Taxes and Tags — A 4% State Titling Tax is applicable on the purchase price of the car, and you are required to pay for the cost of new license tags. (We will take care of registration and the periodic handling of new license tags.) These costs may be paid at the beginning of the lease, or incorporated in the monthly payments.

Your monthly payment will also include a 4% monthly usage tax required by the State of Maryland.

Look through the examples inside and get an idea of what the lease payments would be for the car of your choice. Then, just fill out the short application on the back and send it in to us. We'll get in touch with you quickly with more specific information.

FORD LINE



PINTO 2-DOOR SEDAN

Automatic transmission, manual front disc brakes, 200 cc engine, accent group, color key carpeting.

\$68.74*GRAN TORINO
2-DOOR HARDTOP

Air conditioning, automatic transmission, power steering, power brakes, AM radio, V8 engine, wheel covers, tinted glass, whitewall tires.

\$104.49*

LTD 4-DOOR HARDTOP

Air conditioning, automatic transmission, power steering, power brakes, AM radio, V8 engine, vinyl roof, remote control mirror, tinted glass, wheel covers, whitewall tires.

\$119.04*

MAVERICK 2-DOOR SEDAN

Automatic transmission, power steering, AM radio, accent group.

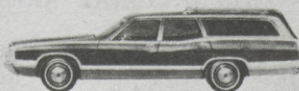
\$79.50*

PINTO SQUIRE WAGON

Automatic transmission, manual front disc brakes, AM radio, 200 cc engine, accent group, color key carpeting

\$86.55*GRAN TORINO
SQUIRE WAGON

Air conditioning, automatic transmission, power steering, power brakes, AM radio, V8 engine, luggage rack, power tailgate window, racing mirrors, tinted glass, wheel covers, whitewall tires.

\$116.44*LTD COUNTRY SQUIRE
6-PASSENGER WAGON

Air conditioning, automatic transmission, power steering, power brakes, AM radio, V8 engine, remote control mirror, luggage rack, power tailgate window, wheel covers, tinted glass, whitewall tires.

\$124.21*

* Monthly payment for 24 months

Does not include state or local taxes

Payment subject to change without notice.

**LOWER PAYMENTS ARE AVAILABLE ON
36-MONTH LEASES**

The CHAIRMAN. Before I call on Mr. Delany, I'm going to have to leave shortly. Senator McIntyre or Senator Sparkman will be here to chair the committee. But before I call on Mr. Delany, I do want to say that I have had a chance to look at all your statements and I, of course, listened with very great interest to the statements that have been delivered and I think you have an absolutely devastating case. It's just beyond me to think what the banks think they are doing getting into the travel business or automobile business. It just isn't banking. There isn't any way you can argue that it is.

The automobile business—and I met with some automobile dealers out in Milwaukee last year and I was very deeply impressed by their case and I think, Mr. Mallon, the remarks that you make on page 14 of your statement couldn't be more right. After all, if you say they can do these things that they are doing in the automobile leasing, it means that they can do anything. This is a credit-oriented society. Everything is on credit. There just isn't any limitation.

Furthermore, as I understand it, the automobile leasing is going to become more and more important as time goes on and many people feel that the majority of automobiles will be procured through leasing rather than through purchase. It could mean that Banks really move in and take over a very important part of the distribution of automobiles. They would have a profound effect on our economy.

As I say, I'm going to have to leave, but I will stay here as long as I can. Mr. Delany is the next witness.

STATEMENT OF JOHN DELANY, ON BEHALF OF THE COURIER AND ARMED CAR INDUSTRIES; ACCOMPANIED BY CHARLES ALLEN, PRESIDENT, ARMORED MOTOR SERVICE CORP. AND PRESIDENT OF THE NATIONAL ARMORED CAR ASSOCIATION

Mr. DELANY. Mr. Chairman, my name is John M. Delany. I am group senior vice president and general counsel of Purolator Services, Inc., and appear here on behalf of the National Armored Car Association and the National Courier Association. I am accompanied by Charles S. Allen, Jr., president of Armored Motor Service Corp. and the president of the National Armored Car Association and a past president of the National Courier Association. We thank you for this opportunity to present the views of these two associations in support of S. 2721.

Mr. Chairman, I would ask that my full written statement be included in the record and, with your permission, I would like to just summarize that statement rather than read it.

The CHAIRMAN. Fine. It will be printed in full in the record.

Mr. DELANY. The membership of the National Armored Car Association and the National Courier Association is made up of substantial firms in American which furnish armored car and courier services throughout the United States. Lists of the names and their locations are attached to my full statement.

We consider that this legislation is important and is now overdue in light of the experiences of our associations under the Bank Holding Company Act Amendments of 1970. We endorse both the sub-

stance and procedural aspects of this bill and we think it will represent a step forward in effecting necessary controls upon the activities of bank holding companies.

In regard to the substantive provisions, we consider that action taken by the Federal Reserve Board in determining that bank affiliates may engage in certain courier services requires the amendment of section 4(c)(8) of the Bank Company Act as this would be accomplished by section 301 of S. 2721. On November 15, 1973, the Federal Reserve Board determined that bank holding companies should be permitted to engage in certain types of courier service. This ruling was based upon the language of section 4(c)(8) as it now reads, with the Board determining that certain courier services were (a) closely related to banking and (b) that this relationship was such as to make these courier services a proper incident to banking.

This ruling was based on the present language of section 4(c)(8). The Federal Reserve Board, in its interpretation of section 4(c)(8), has undoubtedly related its rulings to the views expressed by Chairman Burns during legislative consideration of the 1970 amendments. His position was that the banking system has become very innovative and that the language of section 4(c)(8) should not be framed or interpreted in a manner to hamper this innovation. In support of the Board's ruling that certain courier services may be engaged in by subsidiaries of bank holding companies, the Federal Reserve Board argued that the legislative purpose of the 1970 amendments was to grant the Board "greater flexibility in determining what nonbanking activities are to be permitted bank holding companies."

With this background of the greater flexibility philosophy of the Federal Reserve Board, we believe that the language utilized in S. 2721, at section 301 in amendment section 4(c)(8), accomplishes an essential objectives. Rather than authorizing activities "closely related to banking," S. 2721 provides that the activities shall be "closely and directly related to banking," which is obviously a more restrictive test.

The facts are that armored car and courier services are completely unrelated to the business of banking. Armored car and courier services are basically the business of transportation of property by motor vehicle—and sometimes by plane—whose scope is in considerable measure subject to utility regulatory statutes. Laying out armored car and courier routes and schedules in an efficient and economical manner demands specialized skills. Management of a complex armored car or courier system, frequently calling for close coordination of ground and air services, requires a high degree of expertise, having nothing at all to do with banking skills or experience.

In the circumstances, we would respectfully suggest that legislative reports on S. 2721 put to rest once and for all the Federal Reserve Board concept that a flexible approach should be adopted to section 4(c)(8).

In my discussion of the approach of the Federal Reserve Board to section 4(c)(8), I have referred primarily to the Board's treatment of courier services. The fact is that armored car services also remain in jeopardy under the present language of section 4(c)(8). In the

armored car and courier service hearings, the Board found that "the record is virtually devoid of evidence in support of the proposed amendment—as to armored car service." Despite this determination, the Board specifically left the way open for a bank holding company to make application to engage in armored car services.

Over the years the number of bank holding companies engaging in courier services for others has been extremely limited—never more than three—reflecting that such activity is not one closely or directly related to banking. Nevertheless, the record in the Federal Reserve Board hearing relating to courier services reflected the following activities by one or the other of two bank holding companies which furnished courier service to their correspondent banks and to others:

One: No direct charge for courier service was made, but instead the cost was recovered by adjustments in the compensating balance of the correspondent bank using the service.

Two: In some instances no charge at all was made for courier service for bank cash letters and data processing and in other cases the service was furnished at no profit to the bank holding company subsidiary.

Three: The bank holding company picked and chose those who would receive the not-for-profit service, offering it to those who would furnish the greatest correspondent banking revenue.

Four: In certain instances, solicitation for courier service was made not by courier subsidiary employees but by marketing officers of the bank and other affiliates of the bank holding company.

On the subject of tie-ins, we note in S. 2721 it makes no amendment to section 106(b) of the 1970 amendments, which bars a bank from engaging in tie-in activities. In limiting itself to anticompetitive conduct by banks, the statute fails to deal with such activities on the part of other subsidiaries of a bank holding company. While this void has been filled in part by the Federal Reserve in its regulation Y, it would be our recommendation that this deficiency in section 106(b) be corrected by S. 2721.

Turning to another provision of S. 2721, we observe that it provides at section 301(b)(1) that a bank holding company may continue to engage in activities in which it was lawfully engaged on and since November 1, 1975, "except that such a bank holding company shall not permit the scope or size—in terms of volume of business—of those activities to expand to any significant degree." We believe that an amendment of this nature is essential in light of the Federal Reserve Board's position with respect to a "grandfather" provision in the 1970 amendments. There, in responding to a petition lodged against the expansion of the courier activities of a bank holding company's subsidiary on an intrastate basis and into domestic and international air freight forwarding, the Board stated that "Congress has indicated that expansion of grandfathered activities through internal growth would have a favorable competitive effect and, accordingly, did not place restrictions upon such method of expansion." The absolutely shocking effect of this position of the Federal Reserve Board is that a courier subsidiary holding grandfather rights and engaging in the most limited service could expand from State to State and internationally on a geographic basis and could expand the number and

type of commodities carried by it with no limitation or supervision by the Board.

The CHAIRMAN. Mr. Delany, I hesitate to interrupt you, but I'm going to have to leave now. We are delighted to have Senator McIntyre appear.

Senator MCINTYRE. Have they completed their testimony?

The CHAIRMAN. No. Mr. Delany is the next to the last witness and then he's going to be followed by Mr. Goldstein. Mr. Delany is almost through.

Mr. DELANY. Just about finished.

The CHAIRMAN. I apologize for having to leave. I will certainly go over your statements once again carefully. I think, as I say, they are excellent statements.

Senator MCINTYRE. Go right ahead, gentlemen.

Mr. DELANY. The absolutely shocking effect of this position of the Federal Reserve Board is that a courier subsidiary holding grandfather rights and engaging in the most limited service could expand from State to State and internationally on a geographic basis and could expand the number and type of commodities carried by it with no limitation or supervision by the Board.

We consider that section 301(b)(1) would make it clear to the Federal Reserve Board that limited "grandfather" rights may not be used as a springboard for unlimited expansion. We would recommend that the "scope or size" language of the section be recast to state that the limitation there imposed encompasses both geographic expansion and increase in the nature of commodities carried by the "grandfathered" subsidiary.

With regard to the procedural provisions of S. 2721, we note that section 601(a) includes a new section 9 to the Bank Holding Company Act which provides at subsection (b) that all Board determinations—whether by order or regulation—under section 4(c)(8) shall be made on the record after opportunity for hearing, and the provisions of sections 556 and 557 of title 5 of the United States Code shall apply with respect thereto.

In light of the position taken by the Board in prior proceedings under section 4(c)(8), it is indispensable that this language be enacted into law.

Under the existing law, the Federal Reserve Board has taken the position that such a basic procedural safeguard as the right to such cross-examination as may be required for a full and true disclosure of the facts is a matter of grace, which may or may not be granted by the Board to a participant in a section 4(c)(8) proceeding. This situation must be corrected.

It would also be noted that the Federal Reserve Board ruled that hearings conducted under section 4(c)(8) of the act to determine if particular nonbanking activities are closely related to banking are not subject to appeal to the U.S. court of appeals under section 9 of the Bank Holding Company Act. As a result, we believe it is essential that section 601(b) be enacted into law. This amendment provides that regulations as well as orders may be appealed to the appropriate court of appeals. We would also suggest that any legislative report analyzing the provisions of S. 2721 make it plain that any person

aggrieved by a decision of the Federal Reserve Board on a proposal relating to determination whether a nonbanking activity is closely related to banking shall be permitted to go to the U.S. court of appeals as a matter of right.

Section 601(a), in adding the new section 9(d), provides that, in any proceeding under section 4(c)(8) to which the requirements of the Administrative Procedure Act relating to hearings on the record are applied, an interested party may call for any information or documents, not privileged, for purposes of discovery or for use as evidence. Experience under the present law emphasizes the need for this amendment.

The Federal Reserve Board, in section 4(c)(8) proceedings, has expressly denied access by participants to material which has appeared clearly to be relevant to a proper determination of such matters by the Board. In the hearings related to granting bank holding companies the right to engage in armored car and courier activities, the National Courier Association, the National Armored Car Association and the Independent Bankers Association requested access to intra-agency memoranda considered by the Board in deciding to announce its proposed rulemaking regarding courier and armored car services. The Board denied this request, asserting, as its basis, that section 552 of title 5 of the United States Code specifically exempts from public inspection interagency or intra-agency memorandums or letters which would not be available by law to a party other than an agency in litigation with the agency. In the circumstances there presented, it clearly would have been in the public interest to permit all participants to review these memoranda and to submit for the consideration of the Federal Reserve Board material, data, and the product of experience which would clarify, rebut, supplement, or support the underlying data and conclusions of those internal Board memoranda.

In conclusion, we are grateful for the opportunity to appear before this committee in its consideration of this significant and important legislation. We shall be pleased to answer any questions that you might have based upon our statement.

[Complete statement of Mr. Delany follows:]

STATEMENT OF JOHN M. DELANY, MEMBER, NATIONAL ARMORED CAR
ASSOCIATION AND NATIONAL COURIER ASSOCIATION

Mr. Chairman, Members of the Banking, Housing and Urban Affairs Committee. My name is John M. Delany. I am Group Senior Vice President and General Counsel of Purolator Services, Inc. and appear here on behalf of the National Armored Car Association and the National Courier Association. I am accompanied by Charles S. Allen, Jr., President of Armored Motor Service Corporation and the President of the National Armored Car Association and a past President of the National Courier Association. I thank you for this opportunity to present these two Associations' views in support of S.2721.

The membership of the National Armored Car Association and the National Courier Association is made up of substantial firms in America which furnish armored car and courier services throughout the contiguous United States. Lists of the names and locations constituting the membership of both Associations are attached hereto as Appendices 1 and 2.

I point out at the outset that we consider that this legislation is important and is now overdue in light of the experiences of our associations under the Bank Holding Company Act Amendments of 1970. We endorse both the substance

and procedural aspects of this Bill and we think that it will represent a step forward in effecting necessary controls upon the activities of Bank Holding Companies.

The courier and armored car industries on whose behalf I appear are particularly impressed with the statement of Findings and Purposes of S.2721 that bank holding companies have extended their services into product markets beyond those directly related to banking, thereby eroding the line between banking and commerce in the Nation. Courier services are set forth as a specific examples of such an inappropriate extension of Bank Holding Company activities.

The position of our associations is that S.2721 will enable the armored car and courier industries to continue to perform a vital service to the public unhampered by unfair competitive activities in which Bank Holding Companies may be permitted to engage under the law in its present form.

In order that the Committee may fully appreciate the impact of the Bank Holding Company Act upon our businesses, I believe that it will be useful if I give you a brief description of the nature of the armored car and courier industries.

DESCRIPTION OF THE ARMORED CAR BUSINESS

Armored car companies conduct a specialized transportation business involving the safeguarding and transfer of valuables of every nature. They provide a for-hire transportation and safekeeping service. The commodities transported by armored car companies consist of cash and currency, coin, silver, bullion, stocks and bonds and various other articles of unusual value which require a high degree of care in handling and transportation, such as precious metals and dangerous drugs. The armored car industry provides service, generally, to the following types of customers: banks, chain and retail stores, brokerage offices, currency exchanges, industrial plants (particularly in the delivery of their payrolls) and amusement parks and sporting arenas. Operations are conducted in specially designed armored vehicles, which are constructed of bullet-resistant steel plate and bullet-proof glass and which are equipped with built-in safes and grills. Armored car companies must maintain terminals where specially constructed vaults of various types have been installed in order to provide service for overnight storage and the protection of valuables.

Armored car companies operate in all of the major metropolitan areas of the Nation, as well as from, to, and/or between these areas. Operations of an interstate nature are regulated by the Interstate Commerce Commission while intrastate service is regulated in most instances by state agencies. In order that they may render the most convenient and economical services, armored car companies dispatch their trucks on a scheduled basis or route. By serving as many customers as possible on a route and apportioning the total cost among them, the cost to each customer can be maintained at a level sufficiently low for use by most businesses. By reason of this economic importance of having as many customers as possible on the route, usually only in the Nation's larger cities is there sufficient demand to support more than one or a limited number of armored car companies. The National Armored Car Association has 19 members. It is estimated that there are probably an additional 25 to 30 companies which provide armored car service throughout the United States.

By necessity, because of the great value of the commodities being handled, armored car companies must be reliable and must be well managed. Entrance into the armored car field requires a major investment in highly specialized armored vehicles at a cost in the range of from \$10,000 to about \$20,000 per unit, depending upon size and the equipment built into the unit. In addition, operating terminals which are, by and large, suitable only for single purpose usages are quite expensive due to the high cost of vault installation for overnight storage and the construction of highly specialized security areas which must be equipped with the latest and most sophisticated electronic alarm systems.

DESCRIPTION OF THE COURIER INDUSTRY

Courier companies furnish essential transportation service of time-critical commodities and items. These commodities consist of cash letters for banks; data processing for banks and business concerns; radiopharmaceuticals for laboratories and those destined to hospitals; exposed and processed film for

major processing laboratories; computer repair parts and other repair parts requiring expedited delivery; legal documents for law firms; and a myriad of other small package items, all required to move on precise and rapid transportation schedules. In order to meet the needs of the public utilizing this service, deliveries must usually be completed within 12 hours or less, on a door-to-door basis, from point of origin to point of destination. Courier service includes conveyance of time-critical materials between the East Coast and the West Coast within a 12-hour period. This is accomplished by coordinating ground and air services performed and undertaken by courier companies.

Cash letters involve the daily movement of checks in the process of collection. This service is essential for any small bank shipping its deposits to a larger bank, for collection service on behalf of the small bank and for credit to that bank's deposit account when collection has occurred. Rapid and reliable courier service enables banks to earn interest through the investment of such funds for longer periods. This is a matter of substantial economic importance, particularly in tight money markets, when as much as or more than \$250 a day in interest, per one million dollars, can be earned.

Courier service is usually provided during the evening hours, with pickup after the close of the business day and, in most instances, delivery before the opening of business the next morning. In the courier service provided to banks, cash letters and data processing material must frequently be delivered to or from a large bank within a period as short as three or four hours.

As is the case in armored car service, ground courier operations between the states are regulated by the Interstate Commerce Commission, while service within any given state in most instances is governed by that state's regulatory agency. For service provided in conjunction with air operations, courier companies are regulated by the Civil Aeronautics Board.

The basic unit of any courier service operation, as is true with armored car service, is the route, that is, the cluster of banks and other customers served by the same vehicle. The economic existence of a courier service company is directly and essentially related to the profitability of the structure of its route or routes. By maximizing the number of customers who can be served on any given route, the cost and availability of service to all are enhanced.

It should be noted that the courier service industry is relatively young. Its existence dates from about the early 1950's when a number of individual companies came into being to provide the expedited transportation service required for certain important documents and commodities.

As I have noted earlier, we believe that from both a procedural and substantive standpoint the amendments to the Bank Holding Company Act proposed by S.2721 are highly desirable. In the light of experience under the 1970 Amendments to the Act, the proposals set forth in this legislation are absolutely essential to the accomplishment of important economic objectives and to maintaining the traditional and essential separation of banking and commerce.

SUBSTANTIVE PROVISIONS OF S. 2721

We consider that action taken by the Federal Reserve Board in determining that bank affiliates may engage in certain courier services requires the amendment of Section 4(c)(8) of the Bank Holding Company Act as this would be accomplished by Section 301 of S.2721. On November 15, 1973, the Federal Reserve Board determined that bank holding companies should be permitted to engage in certain types of courier service. This ruling was based upon the language of Section 4(c)(8) as it now reads¹ with the Board determining that certain courier services were (a) closely related to banking and (b) that this relationship was such as to make these courier services a proper incident to banking.

¹ Under Section 4(c)(8), as enacted in the 1970 Amendments, the criteria for approval of a non-banking activity are that it be found by the Board "to be so closely related to banking . . . as to be a proper incident thereto" and that "[i]n determining whether a particular activity is a proper incident to banking . . . the Board shall consider whether its performance by an affiliate of a holding company 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."

The Federal Reserve Board, in its interpretation of Section 4(c) (8), has undoubtedly related its rulings to the view expressed by Chairman Burns during legislative consideration of the 1970 Amendments. His position was that the banking system has become very innovative and that the language of Section 4(c) (8) should not be framed or interpreted in a manner to hamper this innovation. In support of the Board's ruling that certain courier services may be engaged in by subsidiaries of bank holding companies, the Federal Reserve Board argued that the legislative purpose of the 1970 Amendments was to grant the Board "greater flexibility in determining what non-banking activities*** are to be permitted bank holding companies." (Board's Brief in United States Court of Appeals in *National Courier Association et al. v. Board of Governors of the Federal Reserve System*, 516 F.2d 1229 (C.A.D.C. 1975), p. 61.) Inasmuch as the Federal Reserve Board has carried out the "greater flexibility" approach to Section 4(c) (8), it is not at all surprising that S.2721, in its Findings and Purposes, states that "the Federal Reserve has not adequately protected the public interest in approving activities in which bank holding companies could engage . . ." (subsection 2(d)).

With this background of the "greater flexibility" philosophy of the Federal Reserve Board, we believe that the language utilized in S.2721, at Section 301 in amending Section 4(c) (8), accomplishes an essential objective. Rather than authorizing activities "closely related to banking", S.2721 provides that the activities shall be "closely and directly related to banking" (underscoring supplied), which is obviously a more restrictive test.

In approving certain courier activities for bank holding company subsidiaries, the Board followed its "greater flexibility" approach and in doing so clearly moved into an area which is not "closely and directly related" to the banking business. The Small Business Administration, in commenting upon the proposed courier regulation, stated that "now, for the first time, we see what may be a dangerous development for small business creeping up in . . . a proposed rule on armored car and courier services. That is, we see a switch in concept from expanding a service already being *provided by* the bank to proposing to engage in a service that has traditionally been *received by* the bank. In other words, the argument that is being made is that because we, the bank holding company, need a certain housekeeping service, it is closely related to banking and a proper incident thereof". (italics supplied).

The facts are that armored car and courier services are completely unrelated to the business of banking. Armored car and courier services are basically the business of transportation of property by motor vehicle (and sometimes by plane) whose scope is in considerable measure subject to utility regulatory statutes. Laying out armored car and courier routes and schedules in an efficient and economical manner demands specialized skills. Management of a complex armored car or courier system, frequently calling for close coordination of ground and air services, requires a high degree of expertise, having nothing at all to do with banking skills or experience.

On the other hand, the business of banking "... consists in the issue of notes payable on demand intended to circulate as money where the banks are banks of issue; in receiving deposits payable on demand; in discounting commercial paper; making loans of money on collateral security; buying and selling bills of exchange; negotiating loans, and dealing in negotiable securities issued by the government, state and national, and municipal and other corporations." *Mercantile Bank v. New York*, 121 U.S. 138, 156 (1887). See also *In re Prudence Co.*, 10 F.Supp. 33 (E.D.N.Y. 1923); *Rosenblum v. Anglim*, 43 F.Supp. 889 (N.D.Cal. 1942), aff'd, 135 F.2d 512 (9th Cir. 1943)."

In the circumstances, we would respectfully suggest that legislative reports on S.2721 put to rest once and for all the Federal Reserve Board concept that a "flexible approach" should be adopted to Section 4(c) (8).

Before leaving this section of the Bill, we would make certain suggestions respecting its language:

1. That at p. 10, lines 17-18, the words "is likely to produce substantial benefits to the public" be revised to read "will probably produce substantial benefits to the public". We believe that, in terms of a competitive test such as this one, the word "probably" has a more well-defined meaning than "likely". For the same reason, we would suggest that at p. 11, line 11, the words "is likely to" be changed to "will probably".

2. That at p. 10, lines 20-21 and lines 24-25, the words "(i) the term 'substantial benefits to the public' *includes* increased competition . . ." and "(ii) the term 'adverse effects' *includes* undue concentration . . ." be revised to read "(i) the term 'substantial benefits to the public' *refers* to increased competition . . ." and "(ii) the term 'adverse effects' *refers* to undue concentration . . ." (italics supplied).

In my discussion of the approach of the Federal Reserve Board to Section 4(c) (8), I have referred primarily to the Board's treatment of courier services. The fact is that armored car services also remain in jeopardy under the present language of Section 4(c) (8). In the armored car and courier service hearings, the Board found that "the record is virtually devoid of evidence in support of the proposed amendment [as to armored car service]". Despite this determination, the Board specifically left the way open for a bank holding company to make application to engage in armored car services. (Order of Federal Reserve Board, November 15, 1973, amending Regulation Y, Part 225, p. 14).

Over the years the number of bank holding companies engaging in courier services for others has been extremely limited (never more than three), reflecting that such activity is not one "closely" or "directly" related to banking. Nevertheless, the record in the Federal Reserve Board hearing relating to courier services reflected the following activities by one or the other of two bank holding companies which furnished courier service to their correspondent banks and to others:

1. No direct charge for courier service was made but instead the cost was recovered by adjustments in the compensating balance of the correspondent bank using the service.

2. In some instances no charge at all was made for courier service for bank cash letters and data processing and in other cases the service was furnished at no profit to the bank holding company subsidiary.

3. The bank holding company picked and chose those who would receive the not-for-profit service, offering it to those who would furnish the greatest correspondent banking revenue.

4. In certain instances, solicitation for courier service was made not by courier subsidiary employees but by marketing officers of the bank and other affiliates of the bank holding company.

The pervasive and continuing probability of tie-in arrangements on the part of bank holding companies was stated as follows by the then head of the Anti-trust Division of the Department of Justice in testifying on the 1970 Amendments:

"Bank expansion in other areas permits the carryover of economic power into such endeavors. There is, of course, the obvious danger of overt reciprocity or tying arrangements, as well as general favoritism of bank affiliates, particularly in times of tight money. Also, and perhaps more important in terms of the need for present legislation, there are dangers which are of a more structural nature—adverse competitive effects that would tend to develop naturally without actual overt use of the economic power carried over from the banking sphere" (Hearing before the Senate Committee on Banking and Currency, 91st Cong., 2d Sess., pt. 1, at 239).

On the subject of "tie-ins", we note that S.2721 makes no amendment to Section 106(b) of the 1970 Amendments (12 United States Code Section 1972), which bars a bank for engaging in tie-in activities. In limiting itself to anti-competitive conduct by banks, the statute fails to deal with such activities on the part of other subsidiaries of a bank holding company. While this void has been filled in part by the Federal Reserve Board in its Regulation Y (12 CFR 225, Section 225.4(c)), it would be our recommendation that this deficiency in Section 106(b) be corrected by S. 2721.²

Turning to another provision of S.2721, we observe that it provides at Section 301(b) (1) that a bank holding company may continue to engage in activities in

² Section 225.4(c) provides in pertinent part that "[e]xcept as otherwise provided in an order in a particular case, the following conditions shall apply with respect to every acquisition consummated or activity engaged in on the authority of section 4(c) (8) of the Act: (1) the provision of any credit property or services involved shall be subject to any condition which, if imposed by a bank, would constitute an unlawful tie-in arrangement under section 106 of the Bank Holding Company Act Amendments of 1970 . . ."

which it was lawfully engaged on and since November 1, 1975, "except that such a bank holding company shall not permit the scope or size (in terms of volume of business) of those activities to expand to any significant degree." We believe that an amendment of this nature is essential in light of the Federal Reserve Board's position with respect to a "grandfather" provision in the 1970 Amendments (Section 4(a)(2), 12 United States Code Section 1843). There, in responding to a petition lodged against the expansion of the courier activities of a bank holding company's subsidiary on an intrastate basis and into domestic and international air freight forwarding, the Board stated that "Congress has . . . indicated . . . that expansion of grandfathered activities through internal growth would have a favorable competitive effect and, accordingly, did not place restrictions upon such method of expansion." (Letter of Board to counsel for Purolator Courier Corp., dated November 15, 1974). The absolutely shocking effect of this position of the Federal Reserve Board is that a courier subsidiary holding grandfather rights and engaging in the most limited service could expand from state to state and internationally on a geographic basis and could expand the number and type of commodities carried by it with no limitation or supervision by the Board.

We consider that Section 301(b)(1) would make it clear to the Federal Reserve Board that limited "grandfather" rights may not be used as a springboard for unlimited expansion. We would recommend that the "scope or size" language of the Section be recast to state that the limitation there imposed encompasses both geographic expansion and increase in the nature of commodities carried by the "grandfathered" subsidiary.

Our suggestions as to substantive provisions of S.2721 would also include:

1. That Section 4 of the Bank Holding Company Act of 1956 as amended by Section 501(a) of S.2721 be revised at page 14, lines 9-14, as follows:

"... (2) bank and other subsidiaries of bank holding companies refrain from discriminating in favor of their parent holding company or their affiliated subsidiaries in the making of loans or in the establishing of terms and conditions of credit or in the performance of services in the course of engaging in a non-banking activity." (italic words proposed to be added).

2. That Section 9 of the Bank Holding Company Act of 1956 as added by Section 601 be revised at page 15, lines 19-24, as follows:

"(c)(1) In connection with any proceeding under section 4(c)(8), no person shall, directly or indirectly, make or attempt to make any ex parte communication in connection with the subject matter of any such proceeding to any member of the Board or any member of the Board staff participating in such proceeding, nor shall any member of the Board or any member of the Board staff participating in such proceedings make or attempt to make or take part in any such ex parte communication." (italic words proposed to be added).

PROCEDURAL PROVISIONS OF S. 2721

Section 601(a) of S.2721 includes a new Section 9 to the Bank Holding Company Act which provides, at subsection (b), that "[a]ll Board determinations (whether by order or regulation) under section 4(c)(8) shall be made on the record after opportunity for hearing, and the provisions of section 556 and 557 of title 5 of the United States Code shall apply with respect thereto."

In light of the position taken by the Board in prior proceedings under Section 4(c)(8), it is indispensable that this language be enacted into law. Thus, in the Hearings Regarding Courier and Armored Car Services, the Federal Reserve Board stated:

"In the Board's judgment, the regulatory actions under consideration in the subject proceedings do not constitute an order subject to the judicial review provisions of section 9 of the Bank Holding Company Act. Further, the Holding Company Act does not require a formal hearing on the record with respect to such regulatory actions; and no considerations or arguments have been presented to the Board that, in the Board's judgment, warrant a formal hearing on the issues involved in the hearings, as a matter of Board discretion. Accordingly, the motions for formal hearings are denied." (Order of the Board of Governors, January 12, 1972, p. 3).

Under existing law, the Federal Reserve Board has taken the position that such a basic procedural safeguard as the right to such cross-examination as

may be required for a full and true disclosure of the facts is a matter of grace, which may or may not be granted by the Board to a participant in a Section 4(c) (8) proceeding. This situation must be corrected.

In the language I have just quoted, it will also be noted that the Federal Reserve Board ruled that hearings conducted under Section 4(c) (8) of the Act to determine if particular non-banking activities are closely related to banking are not subject to appeal to the United States Court of Appeals under Section 9 of the Bank Holding Company Act (12 United States Code Section 1848). As a result, we believe it is essential that Section 601(b) be enacted into law. This amendment provides that "regulations" as well as "orders" may be appealed to the appropriate Court of Appeals. We would also suggest that any legislative report analyzing the provisions of S.2721 make it plain that any person aggrieved by a decision of the Federal Reserve Board on a proposal relating to determination whether a non-banking activity is closely related to banking shall be permitted to go to the United States Court of Appeals as a matter of right.

Section 601(a) of S.2721, in adding the new Section 9(d), provides that, in any proceeding under Section 4(c) (8) to which the requirements of the Administrative Procedure Act relating to hearings on the record are applied, an interested party may call for any information or documents, not privileged, for purposes of discovery or for use as evidence. Experience under the present law emphasizes the need for this amendment.

The Federal Reserve Board, in Section 4(c) (8) proceedings, has expressly denied access by participants to material which has appeared clearly to be relevant to a proper determination of such matters by the Board. In the hearings related to granting Bank Holding Companies the right to engage in armored car and courier activities, the National Courier Association, the National Armored Car Association and the Independent Bankers Association requested access to intra-agency memoranda considered by the Board in deciding to announce its proposed rulemaking regarding courier and armored car services. The Board denied this request, asserting, as its basis, that Section 552 of Title 5 of the United States Code specifically exempts from public inspection inter-agency or intra-agency memorandums or letters which would not be available by law to a party other than an agency in litigation with the agency. (Order of the Board of Governors, January 12, 1972, p.3) In the circumstances there presented, it clearly would have been in the public interest to permit all participants to review these memoranda and to submit for the consideration of the Federal Reserve Board material, data and the product of experience which would clarify, rebut, supplement or support the underlying data and conclusions of those internal Board memoranda.

Directly applicable to this provision of S.2721 is the statement made by the United States Court of Appeals for the District of Columbia in *National Courier Association v. Board of Governors of the Federal Reserve System*, 516 F. 2d 1229 at 1241. In commenting upon the efforts of the Federal Reserve Board to prevent the disclosure of certain internal memoranda, the Court said:

"Private parties and reviewing courts alike have a strong interest in fully knowing the basis and circumstances of an agency's decision. The process by which the decision has been reached is often mysterious enough without the agency's maintaining unnecessary secrecy. To be sure, the agency may have a strong interest of its own in keeping internal documents from public view, but it will normally be far easier for the agency to establish its interest in suppressing such documents than for the private litigants to establish their interest in exposing them to judicial scrutiny. The proper approach, therefore, would appear to be to consider any document that might have influenced the agency's decision to be 'evidence' within the statutory definition, but subject to any privilege that the agency properly claims as protecting its interest in non-disclosure."

I would suggest that the following language be substituted at page 16, lines 7-9: "any interested party may call upon *and shall be entitled to receive from*" (1) the Board, or (2) in the case of the consideration of an application, the applicant, for any information or documents, not privileged, for purposes of discovery or for use as evidence." (italic words would be inserted).

We are grateful for the opportunity to appear before this Committee in its consideration of this significant and important legislation. I shall be pleased to respond to any questions that you may have on the basis of this statement.

MEMBERS OF THE NATIONAL ARMORED CAR ASSOCIATION

Armored Car Company, Inc., Louisville, Kentucky.
 Armored Car Company, Inc., East Orange, New Jersey.
 Armored Motor Service Corp., Trenton, New Jersey.
 Armored Transport, Inc., Los Angeles, California.
 Arnholds Armored Car Service, Inc., Philadelphia, Pennsylvania.
 Brink's, Inc., Chicago, Illinois.
 Brooks Armored Car Service, Inc., Wilmington, Delaware.
 Berkshire Armored Car Service Co., Pittsfield, Massachusetts.
 Cauley Armored Car Company, Pittsburgh, Pennsylvania.
 Connecticut Armored Car Service, New Haven, Connecticut.
 Federal Armored Express, Inc., Baltimore, Maryland.
 International Armored Service, Providence, Rhode Island.
 Lewis System of Iowa, Inc., Omaha, Nebraska.
 Loomis Corporation, Seattle, Washington.
 Maritime Guard, Inc., Port Arthur, Texas.
 Purolator Security, Inc., Dallas, Texas.
 St. Louis Pay Truck Company, St. Louis, Missouri.
 Wells Fargo Armored Service Corporation, Atlanta, Georgia.

MEMBERS OF THE NATIONAL COURIER ASSOCIATION

Armored Motor Service Corporation, Trenton, New Jersey.
 Bankers Dispatch Corporation, Chicago, Illinois.
 Brink's, Inc., Chicago, Illinois.
 Doyle Armored Service, Inc., Rochester, New York.
 Loomis Courier Service, Inc., Burlingame, California.
 Purolator Courier Corp., New Hyde Park, New York.
 United Clearings, Inc., Los Angeles, California.
 Wells Fargo Armored Service Corporation, Atlanta, Georgia.

Senator McINTYRE. The former chairman of our committee, now chairman of the Foreign Relations Committee, Senator Sparkman, has just arrived. Do you want me to turn over the gavel?

Senator SPARKMAN. No sir, I want you to go ahead. I apologize for not being here, but I have been over in the Senate.

Senator McINTYRE. Well, thank you very much, Mr. Delany.

Now I will call on Mr. Bernard Goldstein, representing the Association of Data Processing. Before you begin, you have a very lengthy statement here of some 16 pages and all of it will appear in the record, but if you can hit the highlights so Senator Sparkman and I can get in a few questions that I'm sure Senator Proxmire would like to have asked, it would be of great assistance. Do you want all these exhibits included in the record?

Mr. GOLDSTEIN. Please, Senator.

Senator McINTYRE. Without objection, these various addenda will be included in the record. Go right ahead.

STATEMENT OF BERNARD GOLDSTEIN, ASSOCIATION OF DATA PROCESSING SERVICE ORGANIZATIONS

Mr. GOLDSTEIN. Thank you, I and my fellow panel members appreciate the pressures that Senators are under in terms of other business.

Senator McINTYRE. Would you tell that to your other constituents and tell it to your neighbors, because some of them don't understand it?

Mr. GOLDSTEIN. I accordingly will abandon any reading of my statement and take the advantage of closing our panel is presentation

and also of recognizing that both you and Senator Sparkman were not with us during their testimony and share with you what for me has been a moving experience.

You see before you representatives of small business, travel agents, data processors, operators of data centers, auto leasing companies, couriers, companies that deliver messages or funds. As small businesses, we are vulnerable; indeed, I suspect that's why we are under attack by the banking institutions. However, our vulnerability is in fact part of the American dream—part of the fabric and the strength of our society—and we are here seeking your support. We support S. 2721. The Association of Data Processing Service Organizations specifically support section 301 and section 401—both the related and public benefits issue and the uniform standards issue. We need your help in the marketplace. Banks are extremely strong institutions.

Our own industry has an interesting and very relevant history. We originally became an industry as a result of the IBM antitrust settlement consent decree in 1956 in which IBM was forced to separate its subsidiary Service Bureau Corporation, which created an opportunity for our entire industry to develop.

I haven't been in this industry for 20 years, Mr. Mallon, because our industry hasn't existed for 20 years. Some of us have survived. Some of us have not survived. Some of us have made fortunes. America's first billionaire, according to Fortune magazine, comes from our industry. So do many bankruptcies. Our average age is young. At 45, I'm an oldtimer in this business—perhaps over the hill—and I bring the message of our industry to you that we have suffered from bank competition.

We have attempted to respond to it through other channels. First, by the process of education. Secondly, we entered a suit in the State of Minnesota against the National Bank and the Comptroller of the Currency. The American Banking Association entered that suit and it was brought up to the Supreme Court on a dilatory action. Out of that case came a landmark decision *ADAPSO vs. Camp*, in which they said we had standing to sue. But our resources were exhausted. The banks had discovered a loophole in the law and the loophole was the one-bank holding company which even excluded review by the Federal Reserve Board under the multiple Bank Holding Company Act.

We then went to Congress. We went to the House where we achieved an extremely supportive piece of legislation which in fact prohibited banks from engaging in data processing services. It provided a laundry list.

This committee then met under the chairmanship of Senator Sparkman. It produced other legislation and that legislation can best be described in the "closely related" language agreed to be the conference committee, which remanded the problem to the Federal Reserve Board.

At the Federal Reserve Board, another series of hearings were held which, of course, resulted in regulation Y.

What came of all this? We find a strange phenomena. For example, banks unwilling to subject themselves to the review of the Federal

Reserve Board now run to the Comptroller of the Currency. Let me relate a case in point. The Chase Manhattan Bank, having failed the review by the Federal Reserve Board on the proposed acquisition of Dial Financial Corp., then decided on its next proposed acquisition expansion into non-banking activities to go to the comptroller—and by the way, I want to say parenthetically that while we support the wording of “directly related,” we don’t think, any more than auto leasing or travel agencies, that data processing services is related to banking at all—granted, we deal in numbers, but I would defy anybody to give me a closer relationship to banking than the fact that we both deal in numbers. We don’t think that data processing service is a directly related activity. I don’t want to confuse our support of the words “directly related” with what, in fact, has occurred in the marketplace.

The Chase Manhattan Bank, to get back to my story, and I know your time is short, then decided that it would not subject itself to this close review by the Federal Reserve Board and went to the permissive Comptroller of the Currency who permitted them to acquire Interactive Data Corp. This is the same Comptroller of the Currency, by the way, who never even responded to a letter from our trade association when we tried to meet with him and explain the position of our industry and our point of view. The Comptroller therefore, despite our series of victories, turned them into empty victories because he denied us the review under the Federal Reserve Board, the intent of the legislation sponsored by this committee and passed by this Congress. Frankly, he not only perverted our opportunity for review but your directives and legislative intent as well.

We recognize a problem that banks face any time they expand out of the traditional areas of banking. In antitrust parlance a term is beginning to get more and more support. It’s called “tying effect”. The tying effect is the effect that does not have to be identified. Let me read you just one sentence in an article from the Wall Street Journal: “The banker with money to lend can use his leverage to sign up a customer for other bank services.” I should also quote for you, but I will not, a longer quote from the policy planning group of the Justice Department.

This tying effect is part of the basic banking relationship. When it’s present it creates an undesirable and indeed unfair competitive advantage. Our association through our documentation presented, suggests that when and if it is in the public interest that banks be permitted to expand in other areas, that the principles of maximum separation applied which go back to the origins of our industry and were endemic to the IBM consent decree of 1956—be introduced; namely, when banks expand outside normal areas, they should be at least obligated to do so under separate corporate names, separate facilities, separate personnel, and indeed, in a separate location. This is a principle that has not only been endorsed by the IBM consent decree but was a decision following a major study and undertaking by the Federal Communications Commission when they examined how common carriers, another regulated industry, were going to best serve the public and permit, if you will, this young and fledgling industry to survive.

I thank you for your attention. I urge you to not simply take care of data processors, but take care of the public and small businesses who have much to offer. For example, our industry has reduced prices by order of magnitude over the last 10 years. It's a risky business but it's an exciting business, but one certainly involving the fabric of our currency system, the strength of our currency system. Our banking institutions need not and indeed should not compete with others unfairly or unlawfully. I thank you.

[Complete statement follows:]

HEARINGS OF THE SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS WITH RESPECT TO:
S2721 "THE COMPETITION IN BANKING ACT OF 1975"

STATEMENT OF BERNARD GOLDSTEIN, DIRECTOR AND
PAST PRESIDENT OF ASSOCIATION OF DATA PROCES-
SING SERVICE ORGANIZATIONS, INC. ("ADAPSO") AND
VICE PRESIDENT OF TYMSHARE, INC., ACCOMPANIED
J.L. DREYER, EXECUTIVE VICE PRESIDENT, ADAPSO,
AND MILTON R. WESSEL, ESQ., COUNSEL

Mr. Chairman and Members of the Committee, my name is Bernard Goldstein and I appear here on behalf of the Association of Data Processing Service Organizations in support of S2721, and specifically Section 301, tightening the "related" and "public benefits" tests, and Section 401, requiring the application of uniform standards, when banks engage in public data processing, directly or indirectly, no matter which federal agency may have jurisdiction at the moment.

Before turning to my testimony, I do want to say I have entitled this presentation: "The Whipsaw of ADAPSO -- A Horror Story" or, "How Conflicts Between the Federal Banking Agencies Permitted the Banks to Defeat a Small Trade Association's Struggle for Fair Competition."

1976 marks the 10th anniversary of our campaign to obtain protection against unfair competition from banks. It is a campaign which has been characterized by great victories in battle all along the way, and yet, thus far, total loss of the war.

First, a word about our Association, commonly called (as are most things in the computer industry) by its acronym, ADAPSO. It was formed in 1961 to represent the service segment

of the computer industry. We produce results in contrast to hardware, which is the physical equipment, and but one of our tools. We represent data centers, time sharing companies, software companies and facilities management companies -- the full spectrum of what has come to be known as the Computer Services Industry. I will be glad to describe these types of companies further, but I know I have only a very short time, and there is much to say. Suffice it to point out that we have 283 company members who operate 699 separate facilities. We are the major suppliers of computer services in this country, which totaled approximately \$3 billion in 1974. Our membership ranges all the way from IBM to the "mom and pop" shop. Most of our members are very small.

We are a new industry which developed only after the 1956 antitrust consent decree between IBM and the government, which split IBM's service division, Service Bureau Corporation, off as a completely separate company and thereby enabled others to compete and survive in this field. Our members are young -- at 45 I am one of the old timers. We have made and lost fortunes in the last decade, including even, according to Fortune Magazine, America's "first billionaire," Ross Perot. It is an exciting industry, full of modern Horatio Alger stories, and as fine an example as one could find that the free enterprise system still works. As a function of our efforts and competitive environment, we are one of the few industries which has reduced price by orders of magnitude over the past decade, bene-

fitting the public and ourselves tremendously. We want to keep it that way. We welcome and thrive on fair competition, but it must be fair, and not improperly influenced by the restraints and other concerns which exist in so many other lines of commerce.

Early on, well over a decade ago, we recognized the dangers of the spill over of market power from other lines of commerce to our own -- other lines that were regulated monopolies, as are banks and communications carriers, or oligopolistic or otherwise fettered. We saw something which we termed "incremental marketing", the use of so-called excess computer capacity employed in one line of commerce, to market computer services in a second line. Obviously, this could result in economies of scale, benefitting the public, and true economies of that kind have never been our complaint. But when the market power of the first line of commerce is employed in the second, something can result called "tying effect" which we regard as frequently unlawful and always improper and unfair. This "tying effect" activity is all over the place. I have in my hand, for example, a Wall Street Journal clipping (published during the recent tight money period) which says "...the banker with money to lend can use his leverage to sign up a customer for other bank services," and the Justice Department, through its Director of Policy Planning, has said "When banks 'ration' credit (or are forced to ration it) rather than raising the price to the point that supply and demand meet, the process

produces unexercised monopoly power -- power that must be abandoned or used through transfer into some other market. It can be done by tying. No coercion is necessarily involved. Rather, the borrower, recognizing the bank's discretion and economic power, is tempted voluntarily to patronize bank-affiliated enterprises in the hope of improving his chances to obtain it on favorable terms. In antitrust parlance, this is now called tying effect -- to emphasize that the economic effect is just as serious as with overt tying... the risks of tying and tying effect are substantial in banking and finance."

Where tying effect exists without some social or economic benefit to the market in the two lines of commerce, we believe the computer services are being offered unlawfully and should be stopped. Where there are real public benefits, as in scale, we believe the two lines of commerce should be kept independent of each other, by application of the very same principle of maximum separation that was applied in the IBM case. In banking, for example, this would mean that the bank's computer services offering would be divorced from its credit operations by using separate and distinct company names, different personnel, separate equipment, operating in a different territory, and as much else as would insure that the customer went where he went because of the product and not the parent.

I could spend all day on this, but I want to tell a story. Therefore, in order to husband my time, I would like to provide the Committee copies of two ADAPSO position papers on this subject. They're somewhat esoteric and legalistic, but for those who are interested, they explain our concern and proposed solution. And I should add that it appears that the law is, in fact, moving in our direction.

Now to my story. Our first effort, beginning in 1963, was to persuade the banking community to use independent service centers, by a process of public information. When that failed the real campaign began. In 1966 we sought to persuade the Comptroller of the Currency to prevent bank marketing of data processing services to the public, as against public policy and a violation of the National Bank Act. I regret to report that the Comptroller wouldn't even favor us with a reply to our request for a meeting so on June 15, 1967 we filed our first lawsuit in Federal Court in Minnesota against the Comptroller and a national bank. The American Bankers Association came in as an additional party.

Their first attack was dilatory and procedural, alleging that we had no standing to sue. That charge went all the way to the U.S. Supreme Court, ending in 1970, with a great but Pyrrhic victory, ADAPSO vs CAMP 397 U.S. 150, a landmark case on standing to sue. But the banks saw the handwriting on the wall. Multiple bank holding companies were subject to Federal Reserve Board control, and the FRB at that time was

somewhat restrictive in its grants of authority to the banks. But one-bank holding companies were exempt -- a loophole through which banks could move. And move they did. The number of one-bank holding companies with data processing affiliates began to proliferate, to the point where ultimately it became clear that ADAPSO vs CAMP could never resolve the problem, no matter how successful we might be on the merits.

The battle focus shifted to the Congress, where we sought elimination of the one-bank holding company loophole. In this broad effort we were again successful (although again, the victory was a Pyrrhic one). In the House we even persuaded the Committee to sponsor and the House to pass a bill which precluded, through a so-called laundry list, the public marketing of most data processing services by banks. But the Senate rejected the laundry list approach and instead adopted the "closely related" and the "public benefits" tests, leaving it to the Federal Reserve Board to decide what was and what was not "closely related" and a "public benefit." A Conference Committee remanded much to the Federal Reserve Board and the battle accordingly shifted to that Agency.

I regret to say that ADAPSO had to preserve its always limited financial resources - even today we have an annual budget of well under \$300,000. We dropped our Minneapolis suit against the Comptroller so that we could focus on the fight before the FRB and, later, the Federal Home Loan Bank Board, where another ADAPSO suit is still pending in Federal Court in Ohio,

seeking to prevent the public marketing of data processing services by permission of that agency. But another data processing services company carried a battle against the Comptroller in Arizona and I am happy to report that on February 2, 1976 Judge Boldt there decided that the Comptroller's ruling permitting end activity is in fact unlawful, just as we had said from the beginning. I would also like to hand the Committee a copy of that decision and hope that Valley National Bank does not learn by this testimony that it may be able to accomplish much of its purpose by creating a holding company structure.

But to go on -- the Federal Reserve Board has been far more responsive to our pleas than either the Comptroller or the FHLBB. It has spoken of applying aspects of the principle of maximum separation to the holding company's offerings of data processing and other activities. It has rejected proposed acquisitions under its tests. One rejection was the proposed acquisition of Dial Financial Corporation by the Chase Manhattan Corporation, a bank-holding company. After this experience the Chase Manhattan avoided the Federal Reserve Board, and the application of the Bank Holding Company Act, on its next acquisition. It acquired Interactive Data Corporation, a computer service company, into a subsidiary, the Chase Manhattan Bank, as opposed to the holding company, after applying to a permissive Office of the Comptroller instead of the Federal Reserve Board. I hasten to add that the Comptroller promptly granted permission to the Chase, so that we were once

again whipsawed. And so was the intent of Congress.

I'd like to hand up a copy of our Executive Vice President's letter of protest in this regard and the FRB response.

As a result of that exchange we had another good meeting with the FRB, in which they conceded that the Comptroller's attitude was different than theirs, but also quite correctly pointed out that there was absolutely nothing they could do about it. Another loophole was in the law created to close a loophole.

I trust this explains why we believe so strongly that there must be conformity in application of the rules as between federal agencies administering substantially the same activities. To do otherwise permits a well-financed and entrenched adversary to employ the whipsaw defense of the "sporting" or "game" theory of litigation which characterizes so much of our dispute resolution process in this country, and results in defeat on procedural and not meritorious grounds. We face much the same problem in the electronic funds transfer area, where the various agencies are all announcing different approaches and where once again the Comptroller's rulings (on branch banking) are being set aside by the courts.

I'd like also to hand up to the Committee a copy of ADAPSO's response to the FRB's request for comments on its proposed EFTS regulations. We like to think that we were the first to point out the deep concerns to privacy, freedom of competition and other basic interests which EFTS involves, and that we

were instrumental in what ultimately led to the creation by this Congress of an EFTS Commission to study these issues. But we are limited in resources and believe therefore, that there is much to be said for the single agency approach which I know some on this Committee are considering, rather than the ad hoc approach of Section 401 which is confined to the bank related activity area.

Some final comments regarding the "related" and "public benefits" tests of Section 301. We like the strengthened language. We hope that it would result in a substantial diminution of bank marketing of data processing services -- a very risky business, which should be left to entrepreneurs like ourselves, and not carried on by institutions such as banks whose financial stability and integrity is of such major importance. (I would welcome the opportunity to expand on the extraordinary risks of this business). We hope also it would always result in application of the maximum separation concept, so that bankers could market only in areas other than their banking area, with different facilities, different personnel and the like.

But I hasten to add that we had these same hopes when the Bank Holding Company Act was last amended. We pointed out to the Committees then considering the matter, however, that these were only hopes and that experience taught that regulatory agencies' perceptions all too frequently are the result of the perceptions of those they regulate. The incestuous movements of key personnel between industry and regulator frequently

facilitate this phenomena. Despite the somewhat more restrictive approval of the FRB, for practical purposes they have not seriously limited the data processing activities of banks under either the banking "related" or the "public benefits" tests. The existing "closely related" language has been construed by the FRB to cover substantially all of the financially significant data services offerings. Perhaps golf club handicap services are excluded, but not the vast bulk of the business which is in payroll, accounts receivable and similar bookkeeping-type services. Similarly, relatively little attention has been paid to the anti-competitive effects of bank offerings on our industry.

We fear the very same results will ensue with the revised test. Banks argue most persuasively that anything dealing with money and bookkeeping is "related" to banking and, albeit perhaps with tongue in cheek, that they must market their alleged excess edp capacity or the public will suffer -- ignoring that capacity can be tailored to need, or (as in the Valley National Bank case) that they even went out to purchase the computer capacity exclusively for their marketing operations. I would like to discuss this further, but did cover it in full in my earlier testimony in 1972 in the House and Senate, copies of which I have here for anyone who might be interested.

I wish I had a week to speak with you. I am convinced the proposed legislation will help secure the currency and the credit and enhance our competition, even if it does not go quite as far as we would like. We urge its passage.

ASSOCIATION OF
DATA PROCESSING SERVICE ORGANIZATIONS, INC.

210 Summit Avenue / Montvale, NJ 07645 / (201) 391-0870



ADAPSO POSITION PAPER

ON

THE INCREMENTAL MARKETING OF COMPUTER SERVICES GENERALLY

As approved at the ADAPSO Board of Directors' Meeting held
in Washington, D.C. on February 24, 1976

Statement of Position:

Except and to the extent justified by the economics of
scale, competition with respect to each product line or
"market" of computer services should to the maximum extent
be kept independent of economic forces external to such
line or market. Independence should be assured by applica-
tion of the doctrine of maximum separation, which requires,
to the extent appropriate, that there be separate facilities,
separate personnel, separate name, and whatever other separation
is necessary to prevent the spillover of economic power
from one separate line of commerce to another.

Discussion:

ADAPSO has previously addressed a position paper to the issue
of incremental marketing (see Position Paper approved October 27,
1972), calling for a presumption of coercion in certain specific

circumstances. This position paper supplements the earlier position, calling in effect for an extension of the presumption and according it the strength of a rule of law. It outlines additional reasons and circumstances where the improper spillover of economic power exists and should be restricted.

Growth of Multi-market Vendors

Although historical trends are rarely as clean-cut and precise as one would like, World War II marked roughly the beginning of the giant multi-market vendor -- the enterprise dealing in unrelated products in different lines of commerce or "markets" -- the conglomerate.

Older large commercial organizations had operated to a much greater degree in single lines of endeavor, such as steel or petroleum or paper, or in closely related activities, such as chemicals or communications. Following the war, names such as Textron and Litton Industries came to prominence; even laypersons began to understand and employ the special language describing the new kinds of activity -- the corporate "raider"; the "take-over"; the "tender offer"; the "stockholder derivative" suit; the "class" action.

These structural changes led in turn to important changes in competitive activity which are only now coming to be recognized and appreciated, and with respect to which our economic and antitrust laws have not yet developed more than the most rudimentary rules. Essentially these changes involved the transfer of economic power over one product, to another product in a different market, influencing the competitive balance in the second market.

It is difficult to express the philosophy of our economic and antitrust laws in one sentence -- perhaps impossible. But if there is one, it is to encourage competition among as large a number of separate and independent entities as possible, in the belief that such competition maximizes freedom of economic opportunity and is therefore good for its own sake, and also that competition benefits the consumer and society at large by rewarding those who improve quality and reduce cost and price. Our early economic and antitrust laws going back to their origins even before the 1890 Sherman Act, focused attention largely on the problems of their day. These were created by organizations operating primarily in a single market and thus with only limited cross-marketing activities. They included such single product actions as price fixing, restrictions on resale and boycotts. The new conglomerate, however, posed a whole different set of concerns.

Other Cross-market Issues

Related to the rise of the multi-market vendor in both time and novelty of issue, were increasing reciprocal trade practices between independent organizations in different markets -- "You buy my product and I'll buy yours." Here the essential concern involves the use of power in one market to achieve advantage in a second, this time influencing the competitive balance in the first as well. And here again the rules were lacking -- and still are. There were, of course, exceptions, such as with respect to the "tie in sale" between two products (in which a customer is required to purchase an unwanted product in order to obtain a desired one in short supply). But much of the latter were the typical kinds of restraint, the "tie-in", for example, often being characterized by overt coercion and other rather obvious misconduct. (Remember World War II -- "You buy three bottles of my unbranded whiskey and I'll sell you one bottle of Johnny Walker Black at the ceiling price"!). It is only relatively recently that terms such as "reciprocity", "reverse reciprocity", and "tying effect" have come into our economic language. In consequence there was then, and still is today, precious little law to guide the company marketing products in different markets, or seeking to use its own market power to influence activity in a market separate from its own.

What restrictions, for example, if any, are there on the sale of paper by the paper manufacturing affiliate of a conglomerate, to its soap manufacturing affiliate? In a period of shortage, can a scarce metal producing affiliate favor without restraint its metal fabricating affiliate over a stranger? Can an independent paper company in any way condition its purchase of soap from a soap manufacturer on the latter's purchase of paper in the same dollar amount ("reciprocity")? When steel and oil are both in tight supply, can an independent steel company ration its steel pipe to petroleum producers which in turn will supply it with much needed oil ("reverse reciprocity")? Can a bank during a period of tight money ration its limited credit to those who give it trust business? Or edp services business ("tying effect")?

As with the unregulated conglomerate, enterprises subject to government regulation similarly sought to expand beyond their historical confines, and were faced with additional issues created by regulatory statutes and commissions -- can banks break out of "banking" as that term is defined by the national banking act? How far may they go in affiliating with non-banking enterprises under the bank holding company act? To what extent will communications carriers be limited

when they expand their horizons beyond the strict business of communications? The list of these issues could go on and on, with the permutations and combinations almost unlimited depending on the type of enterprise involved and the point in the business cycle at which it is examined.

It seems clear enough that the reciprocal practice and government regulation issues discussed above involve similar questions of market definition. If the same product (here equated somewhat simplistically to "market") is involved, for example, two transactions cannot involve the necessary "tying" of two separate products; if an activity constitutes "banking", a restriction on "non-banking activities" is obviously inapplicable. Although perhaps not as readily apparent, the underlying "conglomerate" issue is no different. This is because the very question of whether an entity is a "conglomerate" depends upon whether or not it is operating in multiple markets. Even separate companies joined under a holding company umbrella do not constitute a "conglomerate" if they are all operating in the same marketplace.

Underlying the conceptual legal "market" issue is the ultimate question whether economic restraints are to be placed on activities which would be entirely permissible if related to a single primary product, or market, or line of commerce.

To what extent will such activities be confined, thereby limiting any "spill-over" of competitive advantage from one activity to another? Just how "clean" will each line of commerce be kept?

Definition of "Market"

A single issue is thus common to all of the above concerns -- the question of just what is the relevant "market". The possibilities run the gamut all the way from the market being defined at one extreme as the trademarked or patented product of a single producer, such as a Chevrolet Vega, on at the other extreme to all products which perform a similar function from the consumer's point of view, such as transportation generally (conceivably perhaps even communications, which by one test satisfies the same user need as transportation), or highway passenger transportation (including buses and taxis), or at least passenger vehicles.

These market definition problems are all around us. They are the concern in the on-going struggle between the Federal Reserve Board of Governors and the Comptroller of the Currency as to what non-traditional banking activities banks may undertake. They are an issue in the AT&T-Western Electric

relationship, now under attack in the courts. They are involved in the current spate of litigations regarding the FTC's "line-of-business" reporting requirements and similar disclosure issues being dealt with by the SEC, the IRS and the accounting profession. They are central to the great majority of other government and private antitrust litigations pending in the courts and the administrative agencies; they are at the heart of the government's case against IBM, which turns on the question of IBM's share of the relevant "market." (Is it just general purpose digital computers, where IBM's share may be high enough to constitute "monopoly" in the legal sense? Or does it extend on out to include even software, services and ^{certain other} office equipment, all of which in some respects represent alternatives to more hardware insofar as the user is concerned? If the latter, then IBM's market share is undoubtedly far below that needed to constitute monopoly under present law.)

It's time to get down to fundamentals. What is the optimum solution to this issue in the interest of society at large? Freedom of the individual's competitive activity is a desideratum in our system, so that restrictions should be imposed only where necessary to achieve some preferred objective. Certainly also it is generally desirable to encourage activity where real economies of scale can be achieved, with resulting better product and lower cost and price; computer hardware used in banking should not remain idle and unused, for example, simply because its employment in the marketing of computer services outside banking might

upset a competitive equilibrium. Accordingly, limitations on growth achieved through fair competitive effort should not lightly be imposed.

Growth in a single market resulting from economies of scale or proper aggressive competitive effort, is one thing; growth gained in several different markets, however, may well be another, posing quite different issues. Activities relating to several products can result in the use of power once limited to a single product, to restrain and interfere with the previously existing freedom of competitive activity in another without accompanying social or economic benefit. When huge enterprises with established trade names and reputations and credit positions expand beyond the marketplace in which they have achieved that strength -- presumptively lawfully and properly -- they may endanger the economic climate in the fashion of the elephant stepping on the ant; legal principles relating to unlawful extension of a patent and trademark monopoly are in recognition of this reality. In addition, continued and unrestricted growth under such circumstances, not resulting from economies of scale or development of a single line of related products, can result in increasing aggregations of capital also not justified by any social or economic benefit, thereby creating unnecessary barriers to the entry of others into the marketplace.

Where multi-market activities are concerned and there is danger of impairing free competition in one of the lines involved, then, there may be a benefit to be achieved in isolating "markets" to logical areas of competitive activity, measured by history and the concerns of the producer and the consumer as well as the realities of the marketplace.

Expansion is, of course, desirable where multi-product activities involve true economies of scale and thereby result in lower cost and price. Otherwise expansion into unrelated markets under these circumstances should be limited by the principle of "maximum separation." That doctrine seeks to prevent the spill-over of market power from one line of commerce to a second when not justified by scale or other substantial benefit of some kind, by insulating the separate activities of the multi-product or service vendor from each other through the use of separate facilities and equipment, a different name, different personnel and the like. It would apply irrespective of whether the multi-market activity was the result of the merger or acquisition of independent entities, or achieved solely through internal growth.

There is as yet little case law on this issue, but it is coming. Thus the FTC's Economic Report on Corporate Mergers, dealing with reciprocity, states (pp. 6-7 through 6-11):

The first anticompetitive effect of reciprocity, then, is to change the mechanics of the competitive process by dampening rivalry, based on price, quality, and service.

* * *

It compounds and further rigidifies the already inflexible, administrative process of an oligopolistic market. Similarly, it can be used to stabilize prices when the market is fixed by collusive arrangements.

The second effect is to raise barriers to entry. In the extreme case, potential entrants would find much of the market "tied up" by existing firms. For a new entrant to compete on equal terms with existing firms, it might itself have to resort to conglomeration... reciprocity thus creates a unique barrier to entry, not one based on any real economies of scale, but rather derived wholly from the size and organizational characteristics of existing competitors in the market. The larger and more conglomerated the existing firms become the higher the barrier to entry...when large conglomerate enterprises engage in systematic reciprocity, industrial bigness and conglomeration rather than real economy threaten to become the key to business excess. This is wholly alien to the tenets of a free market economy. The ultimate result is an inflexible economic system composed of an industrial elite knit together by the exchange of reciprocal favors.

Donald I. Baker, then Director of Policy Planning of the Department of Justice's Antitrust Division, and now Deputy Assistant Attorney General in charge of that Division, has said (in dealing with the bank issue in another connection):

When banks "ration" credit (or are forced to ration it) rather than raising the price to the point that supply and demand meet, the process produces unexercised monopoly power -- power that must be abandoned or used through transfer into some other market. It can be done by tying. No coercion is necessarily involved. Rather, the borrower, recognizing the bank's discretion and economic power, is tempted voluntarily to patronize

bank-affiliated enterprises in the hope of improving his chances to obtain it on favorable terms. In antitrust parlance, this is now called "tying effect" -- to emphasize that the economic effect is just as serious as with overt tying... Needless to say, you can expect to hear this argument from me again...for the risks of "tying" and "tying effect" are substantial in banking and finance.

And the argument has been heard again from Baker and others in the Justice Department and Federal Reserve Board. In one form or another "maximum separation" is coming of age. Of course, its precise configuration depends on the special facts of the competitive situation -- what is the minimum restriction required to prevent improper spill-over of power from one market to another: Separate corporate name? Separate marketing or executive personnel? Separate geographic territory? Separate facilities? Restricted inter-market transactions or none at all? All at one time or another have been considered and applied, in the computer industry itself beginning with the 1956 antitrust consent decree between the government and IBM, and continuing with the FCC decision in the computer/communications inquiry, the GT&E appellate court decision and the Federal Reserve Board's Regulation Y and subsequent rulings. There is at least a possibility that some application of the doctrine will ultimately be the resolution of the present government suits against IBM and AT&T.

Computer Services

The computer services industry furnishes almost a textbook example of cross-marketing activities. It has in fact become a key arena for testing their economic impact and significance. This is because more and more companies whose principal products are in unrelated, non-computer services lines of commerce, are marketing the "idle" or "excess" computer capability created by the in-house capacity considered necessary to handle peak loads during limited periods of maximum operation. Profit is possible even if the off-peak reservoir is sold at only slightly above the variable cost associated with the service rendered -- termed by the industry "incremental marketing." Moreover, such companies can frequently expand over a given base quite cheaply, and are tempted to do so and market the over-capacity as well.

The computer services marketplace therefore has been an obvious and attractive target for cross-market expansion.

This of course creates problems for computer services companies. Sometimes the mere threat of cross-market competition can be sufficient to discourage a budding computer services enterprise. At the inception of operations, for example, the ordinary edp services vendor has only a single product line over which to spread its fixed costs. It does not possess a ready and relatively "captive" market or the marketing leverage resulting from the cross-market relationship to cover its break-even costs. In certain types of offerings (such as time-sharing services), the new enterprise must recoup huge start-up costs. Potentially large profits are needed to offset the inherent risks and attract capital. Obviously, these kinds of edp services operators cannot expect to meet the competition of the cross-market operator by pricing their services on an incremental cost basis.

Because of this perceived adverse competitive impact, the computer services industry has for some time been seeking to isolate the competition in what it considers to be its separate markets, from external market advantages. Some of its more significant efforts are the following:

Banks: A nationwide publicity campaign against allegedly improper bank marketing of edp services, beginning in 1963; followed by federal litigation against the Comptroller

and the American Bankers Association which went all the way to the United States Supreme Court; followed by a legislative fight in the House and Senate, resulting in enactment of an amended bank holding company act; followed by still continuing struggles before the FRB regarding application of the "public benefits" test, the current battle to get the Comptroller to adhere to the FRB's guidelines and the pending litigation in Ohio against the Federal Home loan Bank Board.

Communications carriers: The five-year FCC inter-dependence inquiry regarding whether communications carriers may market edp services without restriction; followed by the GT&E battle in the Court of Appeals for the Second Circuit; accompanied by on-going disputes with the many state regulatory commissions and interaction with the FCC as to what is and what is not "communications."

Tax sheltered organizations: A continuing fight to prevent universities, chambers of commerce and other non-profit organizations (such as Blue Cross) from using their tax advantage in non-profit marketplaces in the sale of computer services.

Accountants: An on-going effort to stop accounting firms from using their licensed audit and certification positions to gain advantage in the sale of edp services.

Conglomerates (defined as other multi-market vendors): Still another battle to prevent industrial organizations, including computer hardware manufacturers, from using entrenched positions in their main lines of activity to compete in computer services, plus legislative, administrative and judicial testimony, litigation (such as the Reynolds & Reynolds suit against Volkswagen of America), position papers and published articles and speeches advocating "maximum separation" as the course to be followed, and an effort to make permanent the six-year limitation on IBM's re-entry into the services business.

Electronic funds transfers: The most recent and certainly now the most important part of the struggle. The industry sees an uncontrolled EFTS as linking together virtually every market in this country and the world, with resulting blurring even of previously "clean" market lines and structural rigidity in the economy generally. The industry pointed out this danger to the Federal Reserve Board, urged establishment of the EFTS Commission, and is actively supporting moratorium legislation.

Conclusion:

The computer services industry is a burgeoning one, already operating at the multi-billion dollar level. If all computer services were separately identified and "broken out" from hardware operations, it probably already would be larger than computer hardware. Competition is substantial and effective. But the dangers of impairing that competition are also substantial. Accordingly, except where justified by some other economic consideration such as scale, for all the above reasons competition within the separate lines of commerce within the computer services industry should be protected by the doctrine of maximum separation.



Association of Data Processing Service Organizations, Inc.

551 FIFTH AVENUE, NEW YORK, N.Y. 10017 • (212) 661-0222

Position Paper on The Incremental Marketing of Computer Services as an Unlawful Tie-In Sale

Statement of Position. Coercion should be presumed and an unlawful tie-in held to exist, whenever a seller marketing a product in a separate line of commerce also markets a not insubstantial volume of computer services, and where the following circumstances are present:

1. The first (tying) product is patented or copyrighted, or otherwise a lawful monopoly of the seller.
2. There exists some special relationship between the seller and the purchases which is independent of the particular purchase-sale relationship giving rise to the questioned transaction, such as by way of dealership, franchise or license.
3. The seller offers its computer services only to those purchasing the tying product and not generally.
4. The tying product is important to the business of the computer services organizations in the pertinent market.
5. The seller is of large size relative to the computer services organizations in the pertinent market.
6. The seller operates in an oligopolistic or monopolistic line of commerce.

The number of these circumstances necessary to justify the presumption will vary, depending on the facts of each case. Thus, where 4, 5, and 6 are present, as in the case of communications carriers and banks, 1, 2 and 3 are not required.

The existence of all six should never be necessary.

Discussion. ADAPSO welcomes and encourages fair competition in the computer services industry from any source -- conglomerate, congeneric, manufacturers' subsidiary and independent. However, that competition must be fair.

ADAPSO has fought competition from subsidiaries of communications common carriers and from banks, because of its deep concern about the inherently coercive character of their cross-market activities. It intends to continue its fight to insure that the computer services industry remains competitive.

Cross-market operations, however, are by no means restricted to banks and communications carriers. They are increasingly becoming a feature of the computer services industry. This is because more and more organizations whose principal products are in separate, non-computer services lines of commerce, find themselves with large amounts of "idle" or "excess" computer capability, created by the inhouse capacity considered necessary to handle peak loads during limited periods of maximum operation. Moreover, frequently such companies can expand computer capacity over a given base quite cheaply, and are thus tempted to do so and market the overcapacity. The computer services industry therefore becomes an obvious and attractive target for their cross-market expansion.

Restrictive cross-market impact by organizations such as banks, communications carriers, computer manufacturers' subsidiaries, charities and government organizations, has accordingly for some time been a special and perhaps key concern of the computer services industry. The mere threat of cross-market competition can be sufficient to discourage a budding computer services industry entrepreneur. This is because he knows that cross-market operator sometimes price their public offerings of computer services on an incremental cost basis -- that is, so as to recover only the incremental costs of the offering plus whatever contribution to fixed costs is possible, but

not all fixed costs allocated on an overall product basis, plus profit.

In contrast, at least at the inception of his business, the computer services vendor has only a single product line over which to spread his fixed costs. He does not have a ready and sometimes "captive" market to cover his "nut" (break-even costs). In certain types of offerings, particularly of time-sharing services, he has huge start-up costs to recover. He needs potentially large profits to attract risk capital. Obviously he cannot expect to meet the competition of the cross-market operator by pricing his services on an incremental cost basis.

Price competition is of course a cornerstone of American industry and enterprise. If the cross-market operator has advantages of scale or otherwise and can outperform his computer services rival without restraint of trade or other unlawful act, present law permits him to do so. Under the special circumstances presented by the computer services industry, however, this conclusion often begs the real issue, which is an evidentiary one.

The question of whether there in fact is restraint in cross-market operations involving computer services can be an extraordinarily difficult one to answer. Its resolution can take so long as to preclude remedying the wrong within a meaningful time frame. The intimate relationship between the two products being sold and the esoteric nature of the computer services transactions may be very intricate. For example, how should one cost-allocate the use of an idle computer required for standby or to handle a peak load, or the development of a necessary in-house program redesigned in minor part for marketing purposes? As a result, obtaining and analyzing the evidence necessary to establish the most common and pernicious form of restraint by the cross-market operator, the "tying" arrangement, can take years of litigation and enormous expense. "Tying" arrangements have long been held to be per se unlawful by the United States Supreme Court, because they force

the public as buyer to forego its free choice between the competing "tied" products and deny competing suppliers free access to the consuming market of the tied product. The Supreme Court has said that "the vice of tying arrangements lies in the use of economic power in one market to restrict competition on the merits in another."

Prohibition of cross-market computer services transactions under the described circumstances need not deny the consumer the benefits of competition from these services. The cross-market operator has only to remove the coercive tie-in aspect by applying the now recognized "maximum separation" principle. The public and the cross-market operator are thus not denied any advantages or benefits from scale -- which are often small and sometimes non-existent in the computer services industry -- but simply the marketing leverage which results from the cross-market relationship and the "full line" approach.

The independent (of IBM) computer services industry was conceived in the filing of the United States Government's antitrust complaint against International Business Machines Corporation in 1952. It was born with the consent decree entered in that litigation in 1956. It is thus a very new one. It promises to be huge -- far bigger than hardware. If "bundled" computer statistics are broken out fully, to include operating systems, software may already be a bigger business than hardware.

To this point the industry has been structured along classical free competition lines. It is fragmented into a great number of small economic units. It is characterized by ease of access to many parts of the market, as well as demise from that market. It is highly competitive, but sometimes the competition is cutthroat and destructive. It may have its modern Horatio Alger stories, but it also has disasters.

Because it is new, highly competitive, esoteric, complex, developing

at a rapid pace and endangered, the computer services industry requires protection against the cross-market tie-in threat. The dangers of cross-market activities are apparent. Under the described conditions, the power to coerce is clearly present. The problem of proof is great. The industry should not be made to wait the generation of legal precedent ordinarily needed to establish a factual presumption; by then it could be too late to preserve the computer services industry's present highly competitive state. Recognition of a presumption of coercion in connection with the computer services cross-market tie-in sale by the courts, now, is necessary and proper, and should be made to wait no longer.

IN THE UNITED STATES DISTRICT COURT FILED 2 1976

DISTRICT OF ARIZONA

W. J. FURSTMAN, CLERK
UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF ARIZONA
DEPUTY CLERKNATIONAL RETAILERS CORPORATION
OF ARIZONA, an Arizona
corporation,

Plaintiff

CIV. NO. 71-410-FHX-WEC

v

MEMORANDUM OF DECISION

VALLEY NATIONAL BANK, a national
banking association; and JAMES E.
SMITH, Comptroller of Currency,

Defendants

I. STATEMENT OF THE CASE

This is an action for a declaratory judgment and injunctive relief against the defendant, James E. Smith, Comptroller of Currency (hereafter Comptroller). Plaintiff seeks a declaratory judgment that a ruling, 12 C.F.R. §7.3500, Use of data processing equipment and furnishing of data processing services, issued by the Comptroller is unlawful and should be set aside as arbitrary, capricious and an abuse of discretion, contrary to constitutional rights, power, privilege or immunity and, in excess of statutory jurisdiction, authority or limitations. Injunctive relief is sought to enjoin the Comptroller from issuing any opinion, rule or regulation permitting national banks to perform/data processing services for any person unless the data processing services are directly "incidental" to the express powers of the bank under the National Bank Act., 12 U.S.C. §24.

The factual matrix within which plaintiff seeks the declaratory and injunctive relief involves plaintiff, National Retailers Corporation of Arizona (hereafter NRCA) an Arizona corporation that has been offering data processing services to retailers and others in Arizona since 1966. The data processing services offered by plaintiff require the use of a cash register and computer sold by National Cash Register (NCR). The cash register produces a magnetic tape which can be fed into the NCR computer to produce computer print-outs reflecting various aspects of

1 the customer's business. One of plaintiff's customers, a subsidiary of
2 Hart, Schaffner & Marx, was Hanny's, a retail clothing merchandiser with
3 a substantial number of stores in Arizona and in the Phoenix area.
4 Prior to October 1, 1971, Hanny's was obtaining data processing services
5 from plaintiff. On or about October 1, 1971, Hanny's obtained almost
6 identical services from Valley National Bank (hereafter VNB). The data
7 processing services offered by the VNB to Hanny's and the public, also
8 utilized an NCR cash register and computer combination. The contested
9 service which VNB offers pursuant to the Comptroller's ruling is called
10 a Retail Information System (hereafter RIS). The retailer's sales
11 transaction data, when recorded on NCR cash registers and processed
12 through an NCR computer owned by VNB, can be assembled and compiled
13 into numerous different reports which provide the retailer with
14 information regarding various aspects of his business. A retailer
15 whose sales data has been processed by VNB has the option of purchasing
16 some or all of the reports made available by VNB's data processing
17 service.

18 It is asserted by plaintiff, and the Court finds that, in fact,
19 VNB relied on the ruling of the Comptroller, 12 C.F.R. §7.3500, in
20 providing the data processing services which are the subject matter of
21 this litigation. The Comptroller of the Currency has issued this
22 ruling as being his interpretation of the authority of national banks
23 to provide data processing services under the National Bank Act, 12
24 U.S.C. §24 (Seventh)

25 Plaintiff contends that the providing of data processing services
26 to the public by VNB is not authorized by the express provisions of the
27 National Bank Act, that the Comptroller exceeded his authority in
28 rendering the interpretive ruling in question, and, in effect, induced
29 VNB to provide such services.

30 The Comptroller challenges all of plaintiff's contentions and
31 affirmatively asserts several other contentions, each of which is
32 stated and ruled upon by the Court in paragraph IV below.

The undersigned Judge, sitting in this District by designation, has been assigned to conduct a non-jury trial on the issues now presented in this case. In prior proceedings in the case: (1) on August 21, 1971, Judge William Frey denied plaintiff's motion for a preliminary injunction and entered Findings of Fact and Conclusions of Law consistent therewith; and (2) on October 30, 1975, Chief Judge Walter E. Craig ruled that the VNB should be dismissed from the present action, thus making it unnecessary to determine the motion of VNB for partial summary judgment.

II. SUMMARY OF ISSUES PRESENTED

1. Does the Court have jurisdiction over the subject matter of this action?
2. Does the fact that VNB has been dismissed from this action in a prior ruling render the issues moot?
3. Does plaintiff have standing to assert its contentions in this Court?
4. Are the defendant's contentions, testimony, and exhibits pertaining to electronic money relevant or material to any issues in this action?
5. Are the Findings of Fact and Conclusions of Law entered by Judge Frey in denying plaintiff's motion for a preliminary injunction binding on this Court in trial on the merits?
6. Has the Comptroller of the Currency by issuing and publishing the ruling contained in 12 C.F.R. §7.3500 exceeded his statutory authority, violated constitutional rights or rendered an arbitrary or capricious ruling in abuse of his discretion, or not in accordance with law?
7. If so, should the Court enjoin the Comptroller of the Currency from issuing or giving effect to 12 C.F.R. §7.3500, or any other interpretative ruling or regulation issued by him that would authorize a national bank to perform data processing services this Court finds and holds are not directly authorized by the National Bank Act or within the

"incidental powers . . . necessary to carry on the business of banking"?

III. STATEMENT OF FACTS FOUND

At final argument the Court informed counsel that as a general principle and in the particular circumstances of this case, the rulings of this Court should and would be strictly limited to the specific issues presented in the Final Pretrial Order and the facts found pertaining to those issues. The following basic and controlling facts found by the Court are summarized as below stated. Other detailed and specific findings by the Court are stated in written Findings of Fact and Conclusions of Law signed and entered herewith.

Before plaintiff began doing business in Arizona, its officers and employees had extensive knowledge, training and actual experience in computer providing/data processing services to retail businesses with considerable success in other areas, notably California. Prior to engaging in the same business in Arizona, plaintiff conducted an extensive search for potential customers, and conducted negotiations with them, including Hanny's and others. A customer doing business of the magnitude and with the substantial need for data processing services, such as Hanny's, was essential to plaintiff's entering business in Arizona. A firm commitment by Hanny's to take plaintiff's services on specific terms made it possible for plaintiff to begin business in this state in 1967. After various initial problems were resolved to Hanny's satisfaction over a period of time, plaintiff enjoyed not only a substantial regular income from the Hanny's account but also serviced a considerable number of small retail concerns in various areas in this state which produced significant income for plaintiff.

For some time prior to plaintiff engaging in business in this state Hanny's had a deposit account at the WTB. An executive of that bank, Jere J. Brommer, when plaintiff's service to Hanny's commenced, acquired considerable information concerning plaintiff's data processing services to Hanny's which eventually led him to urge higher bank officials to authorize him to make a thorough study as to whether the bank might

1. profitably provide to the public substantially the same services plaintiff
 2. provided Hanny's. Based on Brommer's study the bank approved his
 3. proposal that the bank purchase its own computers and related equipment
 4. and software from NCR. Over a period of several months, prior to
 5. acquiring the Hanny's account, Brommer, representatives of NCR and
 6. Hanny's engaged in numerous discussions resulting in a commitment from
 7. Hanny's to switch from plaintiff's data processing service to that of
 8. the bank in October of 1971. Subsequent to VNB putting the RIS into
 9. operation Hanny's notified plaintiff that its data processing services
 10. were terminated. The bank charged Hanny's substantially lower rates
 11. than those of plaintiff for essentially the same services. This was
 12. accomplished by all of those who, without advising plaintiff,
 13. participated in bringing about the bank take-over of Hanny's account
 14. from plaintiff. Shortly following this event, plaintiff brought the
 15. present action and, among other claims alleged, asserted the claims
 16. against the Comptroller now before this Court.

18. The subject matter covered and the facts found by the Court as
 19. stated above are based on the trial and deposition testimony admitted in
 20. evidence of witnesses Robert Palmer, Ira Fulton and Lester DeFreese and
 21. to the extent not inconsistent with the above findings, that of Jack
 22. Crawford and Brommer. Brommer and Crawford were highly interested
 23. witnesses. Portions of their testimony might negative any of the fore-
 24. going facts; however, the Court finds such portions incredible upon
 25. reasonable inferences drawn from a consideration of the evidence as a whole.

26. IV. RULINGS RE: JURISDICTION, MOOTNESS, STANDING, ELECTRONIC MONEY,
 27. PRELIMINARY INJUNCTION FINDINGS, COMPTROLLER RULING AND INJUNCTION

28. 1. Jurisdiction:

29. After a full review of the arguments and briefs of counsel as well
 30. as the cited authority, the Court finds and holds that it has subject
 31. matter jurisdiction over this action, established by 28 U.S.C. §1337,
 32. §1331(a) and upon the Administrative Procedure Act, 5 U.S.C. §701, et seq.
 A number of cases hold the Commerce Clause of the United States

Constitution is a significant source for the National Bank Act and therefore jurisdiction is proper under 28 U.S.C. §1337.1/ For jurisdiction under 28 U.S.C. §1331(a) the matter in controversy must exceed "the sum or value of \$10,000" and arise under the "laws of the United States." The present controversy arises under the National Bank Act and interpretive rulings thereto. The Court finds that the sum and the value of plaintiff's right to offer data processing services, which allegedly has been adversely affected by defendant's alleged invalid interpretive ruling, are both in excess of \$10,000 exclusive of interest and costs. See Quinault Tribe of Indians v. Gallagher, 368 F.2d 648 (9th Cir. 1966). Consistent with further rulings herein, jurisdiction also exists under the Administrative Procedure Act. State of Washington v. Udall, 417 F.2d 1310 (9th Cir. 1969).

2. Mootness:

Although not supported by a particularized motion or memorandum of authorities, defendant's contention that dismissal of VNE rendered the present issues moot has been reviewed and is hereby denied. See Super Tire Engineering Company v. McCorkle, 416 U.S. 115 (1974).

3. Standing:

The Court finds defendant's contentions on this subject to be without merit under Association of Data Processing Service Organizations, Inc. v. Camp, 397 U.S. 150 (1970) and Arnold Tours, Inc. v. Camp, 400 U.S. 45 (1970).

4. Electronic Money:

Upon a thorough review of the evidence and argument, the Court finds that the defendant's contentions, testimony and exhibits regarding present and future developments in electronic money to be, as far as the issues in this case are concerned, largely, if not entirely, a matter of

1/ Murphy v. Colonial Federal Savings and Loan Association, 368 F.2d 609, 615 (2d Cir. 1967); Camp v. Community National Bank & Trust Co. of N.Y., 438 F.2d 108 (2d Cir. 1971); Burns v. American National Bank and Trust Company, 479 F.2d 26 (8th Cir. 1972); and Partain v. First National Bank of Montgomery, 467 F.2d 167, 172 (5th Cir. 1972).

speculation and conjecture. Accordingly, all of the defendant's contentions and evidence pertaining to electronic money are hereby stricken from this case.

5. Effect of Findings Entered Denying Plaintiff a Preliminary Injunction:

The findings entered by Judge Frey in denying plaintiff's motion for a preliminary injunction are not binding on this Court in conducting a trial of the merits. Bursten v. Phillips, 351 F.2d 616 (9th Cir. 1965) Sierra Club v. Morton, 348 F. Supp. 219 (N.D. Cal. 1972).

6. Review of Comptroller's Ruling :

The Comptroller is the official charged with the administration of the National Bank Act. Consistent with that duty and in the area of the relationship between national banks and the offer of data processing services, the Comptroller has issued several rulings and written opinions interpreting the provisions of the National Bank Act on the conduct of data processing services by national banks. The first of these pronouncements was issued in June of 1959 and has now resulted in the latest ruling contained in 12 C.F.R. §7.3500, with comments in 39 Fed. Reg. 14195 (April 22, 1974), which reads as follows:

"(a) A national bank may use data processing equipment and technology to perform for itself and others all services expressly or incidentally authorized under the statutes applicable to national banks. For example, as part of its banking business and incidental thereto, a national bank may collect, transcribe, process, analyze, and store, for itself and others, banking, financial, or related economic data. In addition, incidental to its banking business, a national bank may (1) market a by-product (e.g., program, output, etc.) of an above-described data processing activity; and (2) market excess time on its data processing equipment so long as the only involvement by the bank is furnishing the facility and necessary operating personnel.

(b) The provision of data processing services by a national bank to others is subject to the prohibitions contained in 12 U.S.C. 1972 concerning tying arrangements, reciprocal dealing, and price discrimination. In particular, a national bank may not require any party who is or proposed to be a customer for any service or product of the bank to utilize any data processing service offered by the bank, and the bank may not fix or vary the consideration for any extension of credit, lease, or sale of property or provision of another service on the condition or requirement that a customer utilize a data processing service offered by the bank." (emphasis added).

1 The VNB relies primarily upon the foregoing interpretive ruling,
 2 comments thereon, and secondarily on previous opinions and rulings in
 3 offering the RIS to the public, primarily retailers.^{2/} Throughout the
 4 comments to the ruling the Comptroller repeatedly emphasizes the fact
 5 that national banks offering data processing services are limited by
 6 the express provisions of and incidental powers emanating from the
 7 National Bank Act. No express provision of the Act authorizes the
 8 public marketing of the RIS by the VNB. The issue, then, is whether the
 9 RIS is within the VNB's "incidental powers . . . necessary to carry on
 10 the business of banking." 12 U.S.C. §24(Seventh). If so, the RIS may
 11 be properly authorized by the Comptroller pursuant to his duty to ad-
 12 minister the National Bank Act. If not, the Comptroller may not
 13 authorize the RIS or a similar national bank service, for to do so would
 14 exceed his delegated authority and be contrary to the law. It is
 15 evident from the foregoing discussion that this Court must interpret
 16 the National Bank Act and the Comptroller's ruling as related to the
 17 facts presented in this case. Although the Comptroller's opinion is to
 18 be given serious consideration ^{3/} it is the duty of the judiciary to
 19 determine the "legitimate bounds of statutory authority." M&M Leasing
 20 Corp. v. Seattle-First National Bank, 391 F. Supp. 1290, 1295 (W.D.Wash.
 21 1975). Once challenged, the Court must seriously consider the ruling of
 22 defendant and the merits of the challenge levied against it. In
 23 thoroughly examining and considering the issues in this litigation the
 24 Court shall interpret the appropriate provisions of the National Bank
 25 2/ See Findings of Fact Nos 5,6 and 7.

26 3/ Plaintiff, however, points out that a number of the Comptroller's
 27 rulings in 1963 have subsequently been held invalid by the courts as
 28 being incorrect interpretation and application of relevant statutes.
 29 The cases and the subject matters of the voided rulings are as follows:
 30 Georgia Ass'n of Independent Ins. Agents, Inc. v. Saxon, 768 F. Supp.
 31 236 (N.D. Ga. 1967) aff'd, 399 F.2d 1010 (5th Cir. 1968), (insurance);
 32 Baker, Watts & Co. v. Saxon, 261 F. Supp. 287 (D.D.C. 1956), aff'd, 352
 33 F.2d 497 (D.C. Cir. 1965) (underwriting government securities); Investment
 34 Company Institute v. Camp, 401 U.S. 617 (1971) (mutual investment fund);
 35 First National Bank v. Dickinson, 396 U.S. 122 (1969) (armored car se-
 36 and deposit receipts); Accord, Arnold Tours, Inc. v. Camp, 472 F
 37 427 (1st Cir. 1972)(travel agency).

Act flexibly. Undeniably national banks should strive to develop and utilize modern methods and technologies in order to provide their customers with efficient and useful services. Such efforts, however desirable, must not contravene the provisions of the National Bank Act.

Having been presented with the problem of determining the nature and extent of the "incidental" powers of national banks the Court in Arnold Tours, Inc. v. Camp, 472 F.2d 427 (1st Cir. 1972) stated;

"... when one looks at past decisions it becomes apparent that the activities of national banks which have been held to be permissible under the 'incidental powers' provision have been those which are directly related to one or another of a national bank's express powers."

....

"In our opinion, these decisions ^{4/} amply demonstrate that a national bank's activity is authorized as an incidental power, 'necessary to carry on the business of banking,' within the meaning of 12 U.S.C. §24, Seventh, if it is convenient or useful in connection with the performance of one of the bank's established activities pursuant to its express powers under the National Bank Act. If this connection between an incidental activity and an express power does not exist, the activity is not authorized as an incidental power." 472 F.2d at 431, 432.

(footnote added and emphasis added).

For this Court to apply the Arnold Tours standard, which this Court approves and adopts, the relevant express powers of the National Bank Act must be compared to the activity alleged by defendant to be within the incidental powers of national banks, i.e. the RIS provided

^{4/} Merchants Bank v. State Bank, 77 U.S. (10 Wall.) 604 (1870); First National Bank v. National Exchange Bank, 92 U.S. 122 (1875); Woman v. Wallace, 211 U.S. 230 (1908); Miller v. King, 223 U.S. 505 (1912); Clement National Bank v. Vermont, 231 U.S. 120 (1913); First National Bank v. Hartford, 273 U.S. 548 (1927); Franklin Nat. Bank v. New York, 347 U.S. 373 (1954).

by VNB. Having done so, the Court must decide whether the service in question is "convenient or useful" to the performance by the VNB of express powers stated in the National Bank Act. If so, it is within the incidental powers of a national bank. Defendant contends the RIS is very useful to the VNB and national banks in general when considering and processing applications for loans on accounts receivable or for operating capital. National banks lending money for operating capital or on accounts receivable is a function clearly within the express powers under the National Bank Act. 12 U.S.C. §24(Seventh). Upon a thorough examination of the evidence and authorities presented this Court is satisfied that the RIS of the VNB is not "convenient or useful" to the performance by the VNB of express powers under the Arnold Tours standard. Nor is the offering of the RIS without reservation permissible under any reasonable interpretation of the incidental powers provision of the National Bank Act. Therefore, the RIS is not a proper or legal activity within the statutory context of 12 U.S.C. §24(Seventh) and to the extent the Comptroller's ruling and comments authorizes or permits without limitation the public marketing of the RIS by the VNB or other national bank, the Comptroller's ruling and comments are found to be contrary to law and in excess of his delegated authority and are hereby declared invalid.

If the reports available from the RIS service were limited to the processing of applications for accounts receivable or operating capital loans by the VNB this Court would not hesitate to find such activity sufficiently related to the express powers of national banks and within the standard of Arnold Tours, and hold that the RIS as limited was within national bank incidental powers. However, the facts of this case are otherwise. VNB did not limit or intend to limit the RIS to producing information and reports useful in processing and considering loan applications from persons or businesses participating in the RIS. It is because of this wide latitude in the range of persons offered the which is not specifically limited by or excepted from the Comptroller

1 interpretive ruling, that this Court finds the ruling to be beyond the
 2 authority of the Comptroller and contrary to the law as interpreted by
 3 this Court. By so ruling, the Court does not find the Comptroller's
 4 ruling was arbitrary or capricious inasmuch as the ruling, prior to
 5 adoption, was fully considered and widely submitted for comment by
 6 interested persons.

7 Defendant places much reliance on National Courier Association v.
 8 Board of Governors, et al, 516 F.2d 1229 (D.C. Cir. 1975). Although a
 9 Bank Holding Company Act case, defendant maintains National Courier
 10 provides this Court with an applicable and viable test for relatedness
 11 of national bank activities and requires that national banks like VNB
 12 not limit the offer the RIS to bank loan customers because of anti-tying
 13 requirements. As to the test which defendant urges this Court to con-
 14 sider, the Comptroller in the comments to 12 C.F.R. 7.350 contained in
 15 39 Fed. Reg. 14192 (April 22, 1974) acknowledges that the standards for
 16 determining sufficiently related bank and bank holding company activities
 17 are different under the National Bank Act and the Bank Holding Company
 18 Act. That fact sufficiently precludes unlimited reliance on that case
 19 by this Court. In any event, the Court is not persuaded that
 20 defendant has satisfactorily shown that the National Courier standard
 21 is applicable to the instant case. As to the anti-tying contention,
 22 this Court is of the opinion that a national bank may offer and provide
 23 the RIS as a means of providing useful information in processing
 24 operating capital and accounts receivable loans provided that the
 25 granting of such loans is not conditioned upon the applicant's
 26 participation in the RIS.

27 In summary, the Court finds that under the facts of this case the
 28 VNB or any other national bank is not empowered under the National Bank
 29 Act to market the RIS or other comparable service to the general public
 30 or to bank depositors when the performance of the data processing service
 31 is not "convenient or useful" or does not bear a direct relationship to
 32 the bank's performance of any of the express powers specified in the

1 National Bank Act. To the extent the Comptroller's ruling permits or
 2 authorizes such a performance of data processing services without
 3 relation to express powers, it is in excess of his delegated authority
 4 and contrary to law and the Court so finds and holds.

5 Had the RIS of the VNB been limited to use in processing loan
 6 applications or the performance of some other express power under the
 7 National Bank Act, the test of Arnold Tours would have been met. The
 8 RIS of the VNB is not so limited, it has never been performed, with respect
 9 to Henry's, in connection with the VNB exercising any of the express
 10 powers under the National Bank Act, the test of Arnold Tours is not
 11 satisfied and the RIS is not legal.

12 7. Injunction:

13 The Court having found the Comptroller's interpretive ruling
 14 should be limited ^{and} having specified that limitation in the preceding
 15 section, the Court now considers the question of whether defendant
 16 should be enjoined from issuing further rulings, opinions and the like
 17 which are contrary to ^{the} present ruling of this Court.

18 The essence of the Court's opinion is the interpretation of the
 19 National Bank Act as it relates to the offer of data processing services
 20 by the VNB. When the Comptroller issued his ruling, this Court's
 21 decision interpreting the National Bank Act had not been rendered.
 22 The Court's ruling establishes a new interpretation that hopefully
 23 will provide some guidance to the Comptroller in future rulings. In
 24 view of these facts the Court must assume that the Comptroller will
 25 accept and conform to the decision of this Court as long as it remains
 26 viable. Plaintiff having failed to satisfactorily establish that
 27 irreparable injury will result if defendant is not enjoined, or that
 28 future violations by defendant of this Court's rulings are imminent or
 29 likely, the Court declines to issue an injunction.

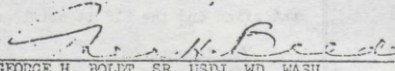
30 CONCLUSION

31 The Court emphasizes its intent and purpose to limit the scope
 32 effect of this decision to the precise factual circumstances pres

1 in the trial.

2 The primary focus of plaintiff's case has been the offer and sale
3 of the RIS by the VNB to Hanny's and to the public and the Court's
4 review of defendant's ruling has been strictly limited to those precise
5 facts. The judgment in this case does, however, have the collateral
6 effect of advising the VNB, although no longer a party to this action,
7 that reliance upon 12 C.F.R. §7.3500 and the comments thereto, in
8 offering the RIS to the public without limitation, is unwarranted.

9 IT IS HEREBY SO ORDERED this 2nd day of February, 1976.

11
12 
13 GEORGE H. BOLLET, SR. USDJ, WD, WASH.
14 Sitting by Designation

IN THE UNITED STATES DISTRICT COURT
DISTRICT OF ARIZONA

FILED
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W. J. FURSTMAN, CLERK
UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF ARIZONA
DEPUTY CLERK

NATIONAL RETAILERS CORPORATION
OF ARIZONA, an Arizona
corporation,

Plaintiff,

vs

VALLEY NATIONAL BANK, a national
banking association; and JAMES E.
SMITH, Comptroller of Currency,

Defendants

CIV. NO. 71-410-MIX-WEC

FINDINGS OF FACT AND
CONCLUSIONS OF LAW

Based upon thorough examination and full consideration of the memoranda and argument of counsel as well as the exhibits and testimony adduced at trial the Court hereby makes the following Findings of Fact and Conclusions of Law. The Memorandum of Decision, filed this date, is made a part hereof and incorporated herein by reference.

FINDINGS OF FACT

1. The plaintiff is an Arizona corporation, incorporated under the laws of the State of Arizona in 1966.

2. The Valley National Bank is a national banking association, whose principal place of business is in Phoenix, Maricopa County, State of Arizona.

3. The defendant, James E. Smith, is the duly appointed and acting Comptroller of the Currency of the United States of America.

4. The Comptroller of the Currency is the official charged with the administration of the National Bank Act.

5. On or about June 9, 1959, the Comptroller's office issued its first written opinion approving the sale by a national bank of certain data processing services to the public.

6. In the March 1964 supplement to the Comptroller's Manual for National Banks, the Comptroller's opinion on the subject was published as an interpretive ruling (12 C.F.R. §7.3500), which stated the Comptroller's view as follows:

"A national bank may make available for the use of others data processing equipment acquired for the primary purpose of performing a service incidental to banking."

7. Paragraph 3500 has been modified and rephrased several times and prior to April 22, 1974, read as follows:

"Incidental to its banking services, a national bank may make available its data processing equipment or perform data processing services on such equipment for other banks and bank customers."

8. On or about April 22, 1974, paragraph 3500 was amended to read as follows:

"(a) A national bank may use data processing equipment and technology to perform for itself and others all services expressly or incidentally authorized under the statutes applicable to national banks. For example, as part of its banking business and incidental thereto, a national bank may collect, transcribe, process, analyze, and store, for itself and others, banking, financial or related economic data. In addition, incidental to its banking business, a national bank may (1) market a by-product (e.g., program, output, etc.) of an above-described data processing activity; and (2) market excess time on its data processing equipment so long as the only involvement by the bank is furnishing the facility and necessary operating personnel.

(b) The provision of data processing services by a national bank to others is subject to the prohibitions contained in 12 U.S.C. 1972 concerning tying arrangements, reciprocal dealing, and price discrimination. In particular, a national bank may not require any party who is or proposes to be a customer for any service or product of the bank to utilize any data processing service offered by the bank, and the bank may not fix or vary the consideration for any extension of credit, lease, or sale of property or provision of another service on the condition or requirement that a customer utilize a data processing service offered by the bank."

9. Beginning in 1965 or 1966, Robert Palmer, acting through his contacts with Hart, Schaffner & Marx in Chicago, and its subsidiary Hanny's in Phoenix, started negotiations by which NRCA ultimately would perform data processing services for Hanny's in Phoenix, Arizona, by using data processing equipment sold by NCR. An agreement was reached with Hanny's through its officer, Les DeFreese, and through officers of Hart, Schaffner & Marx, that Hanny's would receive data processing services from the plaintiff indefinitely as long as the service was satisfactory and the price for that service was competitive.

1 10. In late 1966, or early 1967, the plaintiff originally offered
2 the services described in the booklet called the "8-C Plan."

3 11. During 1967, through 1971, NRCA performed data processing
4 services for Hanny's.

5 12. The plaintiff does not now, nor has it ever owned an NCR 315
6 computer or any other computer.

7 13. In 1968, Mr. Jere J. Brommer, now vice president of the VNB
8 conducted a market survey of some retail businesses in Arizona, including
9 retailers who were obtaining data processing services from the plaintiff.
10 Sometime in 1968, the VNB decided to acquire from NCR a computer and the
11 related programming for the purpose of offering to perform data
12 processing services substantially identical to data processing services
13 being then offered by NRCA in conjunction with NCR.

14 14. In 1969, VNB acquired from NCR an NCR 315 computer, which was
15 subsequently replaced by a more modern computer.

16 15. The VNB owned the 315 computer, its replacement computer,
17 and all other computers on which it performs data processing services,
18 except in extraordinary circumstances when it buys computer time.

19 16. Prior to the acquisition of an NCR computer by VNB, the
20 plaintiff was offering certain data processing services to businesses in
21 Arizona, concentrating on retail businesses. After the bank purchased
22 the computer, VNB competed with the plaintiff by offering similar data
23 processing services to the same businesses or types of businesses.
24 Without the competition from the VNB, Hanny's in reasonable probability,
25 would have continued to be a customer of NRCA for the reasonably
26 foreseeable future, but as a result of the acts of VNB, Hanny's
27 terminated its agreement with the plaintiff as of October 1, 1971.

28 17. Sometime after the acquisition of the NCR 315 computer, the
29 VNB began to offer to the public the data processing services described
30 in the booklet entitled "VNB Retail Information Systems."

31 18. The NCR 315 computer and its related programming was not
32 acquired by the VNB for the purpose of maintaining financial records on

1
2
3 the discounting and negotiating of promissory notes, drafts, bills of
4 exchange, or other evidence of debt; for keeping a record of funds
5 deposited with the bank; keeping a record of the buying and selling
6 exchange coin and bullion; or for keeping a record of loans of money
7 on personal security or obtaining, issuing or circulating notes.

8 The NCR 315 computer and the related programming were purchased by the
9 VNB to offer the Retail Information System to persons whether or not
10 they were customers of the VNB.

11 19. The Retail Information System offered by the VNB to retailers
12 in the State of Arizona is strictly the manipulating of punch paper
13 and optical tapes to produce manager information reports.

14 20. The VNB has offered data processing services to retailers in
15 the State of Arizona in reliance upon the rulings of the Comptroller of
16 Currency, including 12 C.F.R. § 7.3500 and its predecessor rulings.

17 21. In the summer of 1971, Hanny's entered into an agreement with
18 VNB to provide it with certain data processing services commencing as
19 of October 1, 1971.

20 22. Hanny's was a commercial depositor with the VNB.

21 23. The data processing services received by Hanny's after October
22 1, 1971 were essentially the same as those it had been receiving from
23 NRCA prior to October 1, 1971.

24 24. Prior to the changeover by Hanny's from NRCA to the VNB for
25 its data processing services, Hanny's had paid NRCA more than
26 \$250,000.00 for the services provided by NRCA.

27 25. Prior to October 1, 1971, Hanny's had paid to NRCA more than
28 \$5,000.00 per month for data processing services.

29 26. VNB has continued to perform certain data processing services
30 for Hanny's to the present date.

31 27. In 1971 and down to the date hereof the VNB has offered to
32 perform data processing services or has made time available on its

computer for the performance of data processing services that are not in any way incidental to the business of banking such as student records of the Maricopa County Community College District in Maricopa County, State of Arizona.

28. The amount in controversy and the value of the right involved be exceed the sum of \$10,000.00 exclusive of interest and costs.

29. The Court has no evidence before it to show that the Comptroller's ruling is unreasonable, irrational, arbitrary or capricious.

CONCLUSIONS OF LAW

1. This Court has jurisdiction over this matter under 28 U.S.C. §1337.

2. This Court has jurisdiction over this matter under 28 U.S.C. §1331(a).

3. This Court has jurisdiction over this matter under 5 U.S.C. §701, et seq., the Administrative Procedure Act.

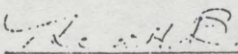
4. This Court is authorized under 28 U.S.C. §§201 and 2202 to grant declaratory relief in favor of the plaintiff.

5. The plaintiff has standing to maintain this action against the Comptroller of the Currency.

6. The Retail Information System as offered by the VNB to retailers in Arizona is not directly incidental to ^{any} one of the express powers of banks stated in the National Bank Act, 12 U.S.C. §24 (Seventh).

7. To the extent specified in the Court's Memorandum of Decision, the ruling of the Comptroller contained in 12 C.F.R. § 7.3500 and 39 Fed. Reg. 14129 (April 22, 1974) is declared invalid, in excess of statutory authority and contrary to law.

DATED this 2nd day of February, 1976.


GEORGE H. DOLLEY, SR. U. S. Dist.
Sitting by designation

5101 P.M.
FEB 2 1976

W. J. FURSTENAU, CLERK
UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF ARIZONA
DEPUTY CLERK

IN THE UNITED STATES DISTRICT COURT
DISTRICT OF ARIZONA

NATIONAL RETAILERS CORPORATION
OF ARIZONA, an Arizona
corporation,

Plaintiff

CIV-No. 71-420 FID-VEC

DECLARATORY JUDGMENT

VALLEY NATIONAL BANK, a national banking association; and JAMES D. SMITH, Comptroller of Currency,

Defendants

The above cause having been fully tried before the undersigned Judge; a Memorandum of Decision, Findings of Fact and Conclusions of Law having been entered; and the Court having fully considered each of the issues presented for the reasons stated in the written Findings of Fact and Conclusions of Law does hereby render Declaratory Judgment as follows:

Defendant, James E. Smith, Comptroller of the Currency, in making and publishing his interpretive ruling contained in 12 C.F.R. § 7.3500 and 39 Fed. Reg. 14195 (April 22, 1975) exceeded his statutory authority and rendered a ruling contrary to law in the particulars stated in the Memorandum Decision of the Court.

It is so ORDERED, ADJUDGED and DECREED this 2nd day of
February, 1976.

Sr. U. S. District Judge,
Sitting by Assignment



ASSOCIATION OF
DATA PROCESSING SERVICE ORGANIZATIONS, INC.

210 Summit Avenue / Montvale, NJ 07645 / (201) 391-0370



January 7, 1975

Mr. Theodore E. Allison
Secretary to the Board
of Governors
Federal Reserve Board
Washington, D.C.

Dear Mr. Allison:

Enclosed is a letter submitted to Mr. James E. Smith, Comptroller of the Currency, regarding his offices present approach to public marketing of data services by national banks. A copy of the letter was sent to Mr. Arthur Burns.

ADAPSO, as the trade association for the computer services industry, is most concerned with the "dual" standard our industry must contend with in acquisitions made by national banks as opposed to one-bank holding companies.

On the one hand, Regulation Y as administered by the Federal Reserve Board "carefully considers competitive impact and overall public benefits evident to the marketing of data processing services by data processing subsidiaries of bank holding companies."

Conversely, the Comptroller's office by Interpretive Ruling and other administrative action, makes it possible for a national bank to market data processing services even in cases in which the tests of Regulation Y might rightfully have denied such permission. It seems to ADAPSO that the spirit of fair competition as delineated in Regulation Y is at cross purposes when a different set of rules is applied to national banks.

A specific case in point was the Comptroller's action in approving the acquisition of Interactive Data Corporation by the Chase Manhattan Bank which is a subsidiary of the Chase Manhattan Corporation.

The Chase Manhattan Corporation's request to acquire Dial Financial Corporation of Des Moines, Iowa was denied by the Federal Reserve Board by order of January 30, 1974. The Board found, "that the aggregate public benefits that may reasonably be expected from the

J. L. DRYER
Executive Vice President

affiliation of applicant and Dial do not outweigh the possible adverse effects of such an affiliation. . ."

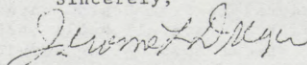
In the first instance, because the bank made the acquisition there was no opportunity for Regulation Y tests to be applied. There is no presumption that the Federal Reserve Board would not have authorized the acquisition, but there was no opportunity for either approval or denial.

This "dual" standard places an additional burden on the computer services industry. Certainly the Comptroller's actions are such that it permits a bank to do directly what the Federal Reserve Board would not permit it to do indirectly.

ADAPSO believes that this development is of such significance to the computer services industry that we respectfully request an opportunity to present our views generally and the Chase Manhattan-Interactive situation in particular to the Federal Reserve Board in an effort to retain the flavor of the tests established by Regulation Y.

ADAPSO will be holding its Board of Director's meeting in Washington in February. Members of our Banking Committee will be present at that time and if it is convenient, we would like to meet with representatives of the Federal Reserve Board on February 13. We appreciate your consideration of this request.

Sincerely,



J.L. Dreyer

JLD:lh
Enclosure

bcc Milton Wessel
Robert Otterbourg
Board of Directors

ASSOCIATION OF DATA PROCESSING SERVICE ORGANIZATIONS, INC.

210 Summit Avenue / Montvale, NJ 07645 / (201) 391-0870



December 9, 1974

Mr. James E. Smith
United States Comptroller
of the Currency
Washington, D.C.

Dear Mr. Smith:

The Association of Data Processing Service Organizations, Inc. ("ADAPSO"), trade association of the computer services industry, is seeking once again your review of your Office's present approach to the public marketing of data processing services by national banks.

ADAPSO's position with regard to this area of incremental marketing is expressed in the enclosed Position Paper. It has been the subject of differences which was appealed to the Supreme Court, several administrative proceedings and lengthy Congressional hearings. Although ADAPSO's view has by no means been totally accepted, we believe that a significant measure of success was achieved by passage of the "one bank holding company" legislation and the Federal Reserve Board's subsequent amendment to Regulation Y and administrative action thereafter.

The Federal Reserve Board both by statute and by administrative interpretation, carefully considers competitive impact and overall public benefits incident to the marketing of data processing services by data processing subsidiaries of bank holding companies. Although ADAPSO and its members may from time to time take exception to specific cases and applications, the test as stated is one with which ADAPSO believes it can live.

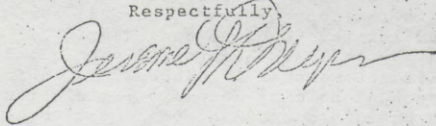
Unfortunately, however, your Office by Interpretive Ruling and other administrative action, makes it possible for a bank, as distinguished from a holding company, to market data processing services even in cases in which the competitive impact is negative and the public benefit such that application to the Federal Reserve Board for acquisition of a holding company subsidiary would be denied. In other words, the effect of your Office's action is such that it permits a bank to do directly what the Federal Reserve Board would not permit it to do indirectly.

The antitrust principle of "maximum separation" suggests that, if anything, it would be preferable to conduct such an activity as an independent entity in a holding company structure, rather than directly or by subsidiary. In logic and common sense, a national bank should not be permitted to perform by itself or through a subsidiary, what the Federal Reserve Board would deny were it operated independently as a part of a holding company structure.

ADAPSO dropped its litigation questioning the legal right of national banks to engage in the public marketing of data processing services, because banks were switching to the holding company structure and the litigation was therefore largely believed to be moot. However, the issue remains, and now appears to have been resurrected. It is one which we would far prefer be resolved by considered review of the underlying economic and social principles rather than legal technicality.

We are hopeful that your Office will review this matter and conclude that it should apply precisely the same considerations to the marketing of data processing services by banks, as the Federal Reserve Board does to independent entities operating as parts of bank holding structures.

Respectfully,



JLD:lh

cc The Honorable Wright Patman
Mr. Arthur Burns

bcc Milton Wessel ✓
Robert Otterbourg ✓
Board of Directors



Executive Vice President

Association of Data Processing Service Organizations, Inc.

551 FIFTH AVENUE, NEW YORK, N.Y. 10017 • (212) 661-0222

March 4, 1974

Secretary,
Board of Governors of the Federal
Reserve System
Washington, D.C. 20551

Re: Proposed Regulations Governing the
Transfer of Funds Through Federal
Reserve Banks

Dear Mr. Secretary:

Enclosed is a Position Paper adopted by the Board of Directors of the Association of Data Processing Service Organizations, Inc. (ADAPSO) at a Special Meeting held in Washington, D.C. on February 20-21, 1974. This paper represents ADAPSO's comments in response to the Board of Governors of the Federal Reserve System's invitation dated November 19, 1973.

ADAPSO is the trade association of the electronic data processing services industry. Its membership includes 686 data centers, time-sharing organizations, software houses and branches located primarily in the United States. We estimate that its Members perform the major part of the data processing services in this country, apart from that performed by bank and bank holding company affiliated organizations.

The Position Paper represents the carefully considered and unanimous view of the ADAPSO Board of Directors. We urge that the Board adopt its recommendation.

Respectfully,

ASSOCIATION OF DATA PROCESSING
SERVICE ORGANIZATIONS, INC.

By

Jerome L. Dreyer
Jerome L. Dreyer,
Executive Vice President

POSITION PAPER #7ADAPSO POSITION PAPER ON THE
"CHECKLESS/CASHLESS" SOCIETYAS APPROVED BY ADAPSO BOARD OF DIRECTORS - FEBRUARY 20, 1974

Statement of Position: It is recommended that the Board of Governors of the Federal Reserve System initiate a comprehensive inquiry into the future economics and social consequences of the coming "checkless/cashless" society.

Discussion: Repeated statements and actions of the banking industry and its government regulators make clear that we are moving toward a "checkless/cashless" society. The rate of such movement is uncertain but the direction appears certain. In such a structure, financial transactions would in large part be handled electronically, without the use of paper.

A most recent significant step has been the Federal Reserve System's Board of Governors' (FRB) statement of November 19, 1973, soliciting comments with respect to the proposed electronic funds transfer system (EFTS). Although the FRB's focus appears primarily directed towards the legal aspects of EFTS, its solicitation is not so restricted. This Position Paper is intended to be responsive to the FRB's request and is available for public dissemination.

ADAPSO has a deep interest in EFTS, both in its capacity as the trade association of the electronic data processing (EDP) services

industry and as a member of the public generally.

As a trade association, ADAPSO believes that an improperly designed EFTS could further exclude non-bank affiliated EDP services organizations from the EDP marketplace. If EFTS is to link together banks, clearing houses, retailers and other commercial organizations into a nationwide (and perhaps ultimately worldwide) integrated economic structure, conscious and aggressive effort will be required to prevent serious anticompetitive effects.

As a member of the public, ADAPSO believes that in the design of EFTS, it is essential in the protection of human freedom that the following factors be taken into account:

1. Personal privacy

Since the data to be accumulated by EFTS makes possible surveillance of the individual's financial history, as well as intimate details of his personal life, it is necessary that guidelines be promulgated to insure that only needed and proper information is accumulated in the EFTS system, and that such information is disseminated only to those entitled to it.

2. Absence of Discrimination

Bank credit and debit cards are the forerunners of EFTS. Today such cards are granted in the sole discretion of issuing credit agencies and have, on occasion, been withheld from such groups as women, the aged or young people without a job history deemed sufficient by such credit agencies. Whether or not such denials are proper under present law, appropriate criteria expressed in regulations are necessary to prevent discrimination when EFTS reaches its full development.

3. Possible Anticompetitive Effects

EFTS' proposed economic links between presently independent economic units could introduce structural rigidity into the national economy, with possible anticompetitive impact as serious as certain licensing and franchising arrangements which have been prohibited by the antitrust laws. Measures are required to guard against such an effect, through the introduction of lawfully promulgated standards permitting rapid and easy coupling and uncoupling between units in and out of the EFTS system.

4. National Catastrophe

Unless measures are taken to prevent the creation of a completely interdependent economic grid, EFTS could tie together presently independent economic units in such a fashion that the breakdown of any one part could impair the whole, in the fashion of the 1965 Northeast U.S. power blackout. Measures are required to preclude the possibility of catastrophic disruption of our economic structure.

5. Human Frustration

The frustration of being unable to obtain understanding response when dealing with some computer systems is already sufficiently serious to have resulted in legislative enactment and judicial decision. EFTS could compound this problem by orders of magnitude. Measures for human interaction must be included in any regulatory framework.

ADAPSO suspects that the foregoing concerns are only the tip of the iceberg, and that the thorough FRB inquiry it proposes would uncover perhaps even more serious issues. When

faced with a similar kind of regulatory proposal in 1966, the FCC launched such an inquiry with respect to the interaction between communications and computers. As a result of the information it obtained, the FCC has been able to take informed action and propose regulations of long-range significance to our economic and social well being. In addition, the materials developed during the FCC inquiry have been most useful to others in and out of Government.

If the FRB concludes that a general inquiry is not justified at this time, ADAPSO believes that it should at least prepare and circulate the Statement required by the National Environmental Policy Act. Such a Statement would identify the important considerations involved, thereby making possible whatever legislative or judicial remedial action might be indicated.

BOARD OF GOVERNORS
FEDERAL RESERVE SYSTEM

-----x
In re :
Proposed Amendments to :
Regulation Y to Implement :
Bank Holding Company Act :
Amendments of 1970. :
-----x

COMMENTS OF ASSOCIATION OF DATA
PROCESSING SERVICE ORGANIZATIONS, INC.

The Association of Data Processing Service Organizations, Inc. ("ADAPSO") is the trade association of the electronic data processing ("edp") services industry. Its membership, which includes 575 data centers located throughout the United States, Canada and the rest of the world, performed approximately half of the edp services volume of business done in the United States in 1970 (exclusive of that performed by banks).

EXHIBIT C

Preliminary Statement

All ADAPSO members of course have commercial relationships with banks, ranging from the essential loan, discount, deposit and trust services which are the traditional services of banking, to the furnishing of edp services to banks and bank customers, and to competition, direct and indirect, with banks engaged in the marketing of edp services.

ADAPSO believes that the competitive marketing of edp services by affiliates of banks holding governmental monopoly grants in banking matters is inherently unfair to these customer/competitor relationships, and inconsistent with the American free enterprise system.

ADAPSO accordingly has a deep and continuing interest in the extent to which banks and their affiliates are permitted to engage in the competitive marketing of edp services.

Summary of Objections

ADAPSO believes that the marketing of edp services, as and to the extent it would be authorized by the proposed amendments to Regulation Y, is not an activity so closely related to banking or managing or controlling banks as to

be a proper incident thereto, and that the public benefits of such activity would not outweigh the adverse effects, within the meaning of the Bank Holding Company Act Amendments of 1970 ("OBHC").

ADAPSO believes that proposed Regulation Y, insofar as it relates to the marketing of edp services, is unreasonably broad and permissive.

ADAPSO believes that the specific language of proposed Regulation Y, insofar as applicable to the marketing of edp services, is uncertain and ambiguous.

ADAPSO believes that proposed Regulation Y is not a proper exercise of the administrative discretion vested by OBHC in the Federal Reserve Board.

1. The Marketing of
EDP Services Is
Not a Proper
Incident to Banking
and Would Have
Adverse Public Effects.

ADAPSO has long believed that the marketing of edp services by banks holding governmental monopoly grants in banking matters and their affiliates, is not a proper incident to banking under the American economic system and that such marketing should not be permitted within the applicable legal tests. ADAPSO's position in this connection

with respect to the provisions of the National Bank Act and the Regulations of the Comptroller of the Currency, is set forth in Association of Data Processing Service Organizations, Inc., et al. v. Comptroller of the Currency, et al., 397 U.S. 150 (1970), 38 U.S.L.W. 4193 (March 3, 1970), pending in the United States District Court for the District of Minnesota.

ADAPSO also believes that the marketing of edp services by an affiliate of a holding company within proposed Regulation Y, cannot 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. It believes the potential dangers of tie-ins and reciprocity would be great, as would other adverse competitive effects, including those resulting from bank affiliates of the holding company holding substantial voting control over other competitors in their trust departments.

ADAPSO's contentions that the marketing of edp services to the extent permitted by proposed Regulation Y is not a proper incident to banking and that the public benefits thereof do not outweigh the adverse effects, are

summarized in the testimony of ADAPSO President Bernard Goldstein and Past President Frank Lautenberg to the Committees of the House of Representatives and the Senate which considered OBHC.

2. Proposed Regulation Y is
Invalid as Excessively Permissive.

§ 222.4(a)(9) of proposed Regulation Y authorizes the marketing of edp services to (i) the holding company and its subsidiaries, (ii) other financial institutions or to (iii) "others" ("others" is without stated restriction except for use of the disjunctive "or," which would exclude service to the holding company and its subsidiaries and other financial institutions if such "others" are being served -- apparently an effort to avoid tie-ins. If the intent were unrestrictive in this latter regard, the inclusion of clauses (i) and (ii) would be unnecessary.)

Unless the word "others" is somehow restricted beyond the effect of the disjunctive coupling, the proposed grant is excessive as purporting to justify even edp services to NASA in connection with the calculation of re-entry speeds for an Apollo mission.

The OBHC legislative history makes abundantly clear that the main reasons advanced for allowing bank

holding company affiliates to engage in edp marketing activities, were because of the need to dispose of alleged "excess computer capacity" and as a necessary and integral part of traditional bank services. Yet § 222.4(a)(9) is not geared in any way to the use by the bank subsidiary of so-called "excess computer time" or "excess computer capacity" nor to any relationship of edp services provided to a specific traditional banking activity. Proposed Regulation Y should be limited in these regards, as OBHC requires.

3. The EDP Marketing Provisions of Proposed Regulation Y Are Invalid as Uncertain and Ambiguous.

§ 222.4(a)(9) of proposed Regulation Y is not sufficiently precise in a number of important respects, including the following:

1. The meaning of the word "principal" should be clarified. Does it mean more than 50%? Is it the "principal portion" at any instant of time? Or is it the average over a month or other accounting period? If so, how is the period to be determined? If the proposed Regulation Y is intended only to distinguish between internal and external edp services - which is not its stated impact - provisions should be included to assure that the edp subsidiary does not

simply increase its own work -- whether economic or not -- so as to always keep external edp effort less than a "principal" part.

2. The reference to "principal" undoubtedly is an effort to carry out the Congressional OBHC purpose that a bank affiliate's edp marketing activities result from alleged "excess computer time" or "excess computer capacity." Accordingly, it should be made clear that the "principal" reference is with respect to each specific computer of a bank affiliate, and that the affiliate may not compute "principal" using multiple computers (e.g., eleven identical computers, six of which are used exclusively for the bank and five exclusively for outsiders); or using multiple data centers (e.g., eleven centers, six of which serve the bank exclusively and five of which are exclusively for outside marketing activities); or acquire excess computer capacity, even if in a single computer, where the purpose is to serve outsiders (e.g., the acquisition of a time sharing computer which is clearly not required for the bank's internal operations).

3. The meaning of the phrases "such persons" and "such services" should be clarified. If the phrase "holding company and its subsidiaries" includes the subsidiary providing the edp services, the provision of "such services" for "such persons" would necessarily always equal the total of edp services supplied -- thereby rendering the reference to "principal" meaningless. If the phrase means all subsidiaries other than the one furnishing the service, the holding company is given freedom to increase the volume of services for outsiders by simply transferring volume from other holding company affiliates to the edp affiliate -- again whether or not it is economic to do so.

4. The word "value" should be clarified. If value means "price," provisions should be included as to how it is to be determined with respect to services performed by a holding company affiliate for itself and as to how such internal pricing is to be audited and with what controls as to internal accounting, internal incremental costing, internal pricing and the like. Those aggrieved by the edp affiliate's activities should be furnished means to permit inquiry into questionable internal prices and costs.

5. The phrase "data processing services" should be clarified. As used, it fails to differentiate between the tremendous variety of edp services now offered, which range from those for strictly bank-related purposes to those applicable to purely scientific applications, without distinguishing those which are and those which are not considered to be incident to banking.

6. Although the customers included in subcategories (i), (ii) and (iii) are logically joined in the disjunctive, the purpose apparently being to avoid tie-ins (as stated above, the conjunctive would render the use of subcategories other than "others" meaningless), in order to avoid any possibility of confusion or mistake, it should be made clear that the edp subsidiary may service any one of these subcategories, but not more than one.

7. ADAPSO has been very cautious that the industry does not improperly or unlawfully perform accounting services in violation of state law. To the extent that the use of the word "bookkeeping" suggests the contrary, OBHC and administrative action thereunder might be considered to supersede state law in this regard. It should be made clear that proposed Regulation Y is not intended to authorize edp affiliates to market bookkeeping data processing services in violation of any state licensing law.

Proposed Regulation Y as it stands does not furnish sufficient standards to permit administrative application with the required degree of fairness and certainty.

CONCLUSION

The Board of Governors of the Federal Reserve System should withdraw the proposed Amendments to Regulation Y insofar as the marketing of edp services is concerned, and make clear by rule, regulation or other proper administrative action that such activity is not so closely related to banking or managing or controlling banks as to be a proper incident thereto, and that the public benefits thereof do not outweigh the adverse effects.

Dated: New York, New York
February 24, 1971

Respectfully submitted,

ASSOCIATION OF DATA PROCESSING
SERVICE ORGANIZATIONS, INC.

By

Bernard P. Goldstein
Bernard Goldstein, President

Senator McINTYRE. Thank you.

I have a number of questions. Senator Sparkman, would you like to comment?

Senator SPARKMAN. I'd rather you went ahead.

Senator McINTYRE. I'm going to ask a few questions in light of the testimony. I think that one of the leadoff witnesses was Mr. McMullen. Your statement of your travails with the Comptroller's office is consistent with the testimony of others before this committee. Now is it unfair to state in your view that bank regulators tend to watch out for their banks reflecting a sense of constituency among the government regulators and the regulated? Do you think it's unfair for you to say that in your experience? Do you have that feeling?

Mr. QUINN. If I may Senator McIntyre, I think it's very clear in the case of the Comptroller's attitude about encouraging national banks in engaging in nonbanking activities this is a manifestation of that inherent conflict of interest that he has.

If you look back to 1963 then-Comptroller Saxton not only denied requests by travel agents to curtail bank activities in the travel industry, actually but encouraged them to do it as a device, in his own words, to attract bank customers. So he has no regard, it seems to us, for the impact of his rulings on non banking interests, but is concerned exclusively with encouraging expansive bank activities regardless of the consequences.

Senator McINTYRE. Mr. Mallon, this committee has heard testimony from Secretary of the Treasury Simon. Since banks have tax depreciation advantages from leasing and other activities, they no longer need tax-free income and are moving out of municipals.

What is the total volume of leasing activity undertaken by banks in recent years and what is it projected to be in the future?

Mr. MALLON. Senator, I cannot answer that question as to the exact amount. We could supply the answer to it regarding the growth.

As far as projected growth in the motor vehicle field of leasing, there have been estimates that it may be anywhere from 35 to 40 percent by the early 1980's. However, most of those projections were made in the early 1970's when we did not have a serious energy issue confronting this country and there's been a change in the whole motor vehicle market, as you well appreciate, because of the dimensions of the energy impact question. So it may not be the 35 or 40 percent in the 1980's as was earlier projected in the early 1970's, but there's going to be a growth. There's no question about that.

Senator McINTYRE. Mr. Delany, how important is it that the procedural provisions of the bill requiring Federal Reserve regulations and orders to be made only after opportunity for cross-examination and on the record? Do you regard that *ex parte* communication between the banks and the Federal Reserve as being a problem for bank competitors?

Mr. DELANY. I think it could be a potential problem, Senator. The extent to which it takes place—I wouldn't want to be in a position to accuse anybody of *ex parte* communication. In our industry's experiences before the Federal Reserve Board in 4(c)(8) proceedings, and as I point out in my statement, there were certain memorandums and information that we understood were in the files that were used as a

basis for having hearings in this area that we were denied access to, and I think it's a natural occurrence for an agency such as the Federal Reserve Board that regulates banks to have close contact with the banks in areas that are not subject to litigation or hearing or administrative procedures, and there's a natural tendency for the Board to be in contact with banks and that's why we do support that portion of S. 2721 that would prohibit such ex parte contacts if they do take place.

Senator McINTYRE. Thank you.

Mr. Goldstein, in the light of your experience with the Comptroller, do you view his office as being a dispassionate and responsible agent of government? You cited the Chase Manhattan case in your testimony. Are you familiar with the Bankers Trust situation where the Comptroller approved an activity respecting the identical company which the Federal Reserve Board had ruled was not engaged in activities closely relating to banking? Would you say there's a need to abolish the Comptroller's office? Needless to say, these are Senator Proxmire's questions.

Mr. GOLDSTEIN. Senator, I'm going to suggest that one part of that question answers itself. This is not a dispassionate agency at all. This is an agency that never responded to a letter that we sent some 10 years ago when we were seeking to simply educate the then chairman of that agency as to the views of our growing industry. I have here before me a copy of that letter as part of my testimony and I'd like it entered into the record.

Senator McINTYRE. Without objection, it will be included in the record.

[Letter follows:]

ASSOCIATION OF DATA PROCESSING SERVICE ORGANIZATIONS, INC.,

November 22, 1966.

HON. WILLIAM B. CAMP,
Comptroller of the Currency,
Washington, D.C.

DEAR MR. CAMP: I am writing to request an opportunity to meet with you at your earliest convenience in order to present our Association's complaint with regard to what we believe to be the unlawful marketing of electronic data processing services by many national banks.

After exhausting all other possible sources of administrative and executive relief, our Association has reluctantly adopted the following resolution:

"Whereas, the Officers and Directors of the Association of Data Processing Service Organizations, Inc. have received a continuing and very substantial number of complaints from Members with regard to serious damage resulting from the unlawful marketing of electronic data processing services by banks, and

Whereas, the Board of Directors views with serious alarm the accelerating growth in the marketing of such services by banks, which it considers to pose a threat to the competitive welfare of its Members and even to its own continued successful existence; and

Whereas, the Board has determined to take such action within its limited resources as it may lawfully, in an effort to put an end to this illegal action, Now, therefore, it is unanimously:

Resolved. That to the extent permitted by law, and within the practical limits of its resources, ADAPSO will assist and participate in judicial proceedings instituted to end the unlawful marketing of electronic data processing services by banks."

We are hopeful that our presentation will convince you that the activities of many national banks in the data processing service business are not incidental to the business of banking, and hence are not activities in which national banks may properly engage. Accordingly, our Association's Executive Committee has directed that we present our application for relief to you as the new Comptroller of the Currency, before taking any further action to implement the foregoing resolution.

I hope you will find it possible to grant this request for an early meeting.

Respectfully,

SALVATORE PARISI,
President.

Mr. GOLDSTEIN. Further, we have found this agency to suffer by the incestuous movement of personnel back and forth between the industry it regulates and the regulators. It's an unfortunate part perhaps of our society. I sat in this room before this hearing began today and heard for the first time a new officer of the Housing Department being interviewed by Senator Proxmire. His predecessor was attempting to arrange consulting contracts before he left office. It's sad, but frequently a necessity when a government officer leaves to seek further employment that he is logically driven in the direction in which he's expert. We find in data processing, and I suspect other people find in other industries, that with the close relationship between regulator and regulated, adversely affects a new industry unfavorably. We do not find dispassionate hearings.

In response to your third question, I'm not familiar with the issues of the Bankers Trust case and can't respond to it. The case I picked and included in my testimony was the Chase Manhattan Bank matter, which was a data processing matter, and therefore, one I was familiar with.

Senator McINTYRE. Mr. McMullen, how imperative is it that the procedural protections in this bill guarantee due process?

Mr. McMULLEN. It's critical. We think, number one, that it's critical and the sooner they are imposed the better. For 10 years we have been fighting with them and we share the grave concern here of many other people and so, as I say, we heartily endorse it and we hope it moves forward as quickly as possible.

Senator McINTYRE. Mr. Mallon, can you give the committee an example of just how banks market automobiles, their advertising, accessory sales and repairs, and how does the customer shop at the bank for a car? What happens to the car at the expiration of the loan? Does the bank take possession of the car and is it sold as a used car?

Mr. MALLON. Senator, we have added as companion material to our testimony examples of ads run by banks throughout the United States as a way of inducement to consumers that they can get discounts, as I mentioned earlier, on tires and related services and what have you. As far as the marketing procedures, the banks are talking about indirect and direct leasing programs. Now they are not too visible presently on a national basis with direct leasing programs and there's a strong reason for that, they are very aggressive in the indirect area which when you really fully analyze it it's a misnomer because it's truly a direct basis as well. But, nevertheless, what they do is they sign up dealers for their indirect leasing program and then they advertise for those consumers who are interested in pursuing the lease

avenue to contact one of their dealers signed up in the program. The consumer would then come into the dealership indicating that he would like to sign up on the lease program and by formula the bank says to the dealer, in effect, in certain model automobiles we will provide you front-end money.

Let me give you an example. On the standard-sized car, they might say the front-end money will be \$400 and I think I can really put this in very clear perspective by giving you this example. Let's take a totally independent lessor, like Fleet Leasing Co., and let's take an independent lessor but related with an automobile franchise to a manufacturer, such as Mallon Motors, Inc., and then let's take the bank leasing program. If the consumer would go into Fleet Leasing and inquire about a standard-size car, Fleet Leasing would make a determination from whom it would desire to buy that vehicle and undoubtedly because of the marketing practices pay anywhere from \$50 to \$100 over invoice to the dealer from whom it would purchase. Mallon Motors, being a Ford dealer, let's say we're talking about a Chevrolet, could call a Chevrolet dealer and say, "I have a leasing prospect. How much would you sell me that particular Chevrolet?" And the standard practice would, once again, be somewhere around \$50 to \$100 over invoice.

However, in the bank situation, they will say to that dealer, "We'll pay you \$400 over on that particular car. You supply the car. We set up the lease transaction and we handle it from there on and you're totally out of it." Now these gratuitous situations are a beautiful romance at this point and we know pragmatically that's what it is, a romance, because philosophically, down the road, when the bank is able to convert directly to their direct leasing program by having virtual control over the lessee, they will then dictate what price they are going to be paying in the market for the acquisition of cars and they are going to come to the point of saying as an argument, "We can't continue to pay these high prices in purchasing these cars when other fleet operators are paying \$50 and \$100 over." This is what's going to happen, but they are willing to pay these very high, inflated prices at this point in order to get the lease on their books and once they get them on their books and their whole advertising program they will have the envelope stuffers with monthly statements and everything else. But we know this full well. This is the approach that they are going to be using and the reason you don't hear very much about the bank leasing program any more—and you will find in the transcript of the testimony in the western district court of Washington at Seattle, that Seattle first testified that it only had three direct leases on the books since it began its automobile leasing program in January 1973, and our counsel asked them: "What caused you to cease and desist for a while from the direct leasing program?" Well, it's very evident. When we filed the lawsuit questioning the legality for the Comptroller to interpret the statutes and allow them to get into leasing, that's what caused them to get out of the direct method temporarily.

Senator MCINTYRE. Mr. Goldstein, the last question I will ask before yielding to Senator Sparkman, in view of the size of the companies in your market, how well do you think you can compete against

banking organizations which might enter your business, and give us an idea of the size of the firms in your market compared to bank holding company competitors?

Mr. GOLDSTEIN. The typical firm in the computer services industry has gross revenues of approximately \$550,000 to \$600,000 a year. It's typically started by a computer technician servicing his local community. The largest independent firm in our industry has revenues perhaps of \$220 million and it scales down rapidly to that low average size. Many firms in our industry have revenues of \$300,000 or \$400,000.

The advantage that the banks have in respect to that type of competition are twofold. Number one, their enormous financial reserves, an issue which has been addressed by others before this committee and I will not take your time to repeat them. The far more serious advantage over and above those financial reserves is the marketing advantage, the very nature of the relationship between the bank and data processor users. After all, a vast majority of data processing involves the production of payrolls, the tabulation of sales statistics, accounts receivable, the standard bookkeeping-accounting type of applications. That type of service is sold frequently to small businessmen. Small businessmen are very dependent upon credit for their businesses. The implied, or covert, or tying effect, call it what you will, of that relationship—that need, that requirement for credit—is an awfully persuasive, powerful, destructive marketing tool against us as competitors in the marketplace.

Senator McINTYRE. Senator Sparkman.

Senator SPARKMAN. Thank you, Senator McIntyre. I regret that I was not able to be here to hear your original statements and I still am not clear on just where we are and where we are going, and I guess that's true with you folks, too.

I believe you mentioned something about the one-bank holding company act. Does this grow out of that?

Mr. GOLDSTEIN. Senator, I believe, in large part, it does. The 1970 Bank Holding Company Act remanded a great deal of supervision and authority to the Federal Reserve Board. We may, and indeed do, argue with a lot of the positions the Federal Reserve Board has taken, but at least there's an opportunity to be heard in that particular agency.

The example that I gave—and I don't want to repeat myself, but I think it illustrates better than all the language I could put before you—the Chase Manhattan Corp. is a holding company and therefore subject, if you will, to the legislation that emanated from the committee under your chairmanship. However, the Chase Manhattan Co., for reasons best known to it, and which I can surmise, decided when it was going to acquire a data processing subsidiary and that it would avoid going to the Federal Reserve Board and therefore be subject to your legislation and, instead, proposed that acquisition through a bank subsidiary corporation, a national bank, and then went to the Comptroller of the Currency because that was his regulatory area.

That's the way the pie is cut between the two agencies and it was that agency that approved the transaction. We question whether the

Federal Reserve Board would. We will never know. The Federal Reserve Board never had the opportunity. We never had the opportunity before the Federal Reserve Board and, sadly I say, the legislation of this Congress therefore was not followed in terms of what I suspect was your intent when that legislation was passed.

Senator SPARKMAN. Now a little bit ago you used the expression "closely related" business. That was the language in the Bank Holding Company Act. I remember quite well the difficulty we had in conference and I think that was the key phrase that we agreed on in the conference, "closely related," and of course one activity might be closely related in the eyes of one person and not in the eyes of another. So as I recall, and this is going back for some time—that was 1966—

Mr. GOLDSTEIN. 1970.

Senator SPARKMAN. We more or less made the Federal Reserve Board the referee, didn't we?

Mr. GOLDSTEIN. Sir, you did.

Senator SPARKMAN. And do I understand that you say that instead of going that route, the Comptroller issued some kind of edict?

Mr. GOLDSTEIN. Yes, sir, I say that the Chase Manhattan Bank decided to go to the Comptroller with an acquisition of a computer services company, I suspect, because it was a more permissive agency. Remember, they had just been turned down on a proposed acquisition of a consumer finance company some months before by the Federal Reserve Board.

The problem with "closely related" at the Federal Reserve Board is that it's very broadly interpreted there. For example, in data processing, the Federal Reserve Board—and this was promulgated in regulation Y—permitted virtually all types of data processing services to be offered by banks except the very obscure, and by the very obscure, I'm not trying to be humorous. I'm talking about the fact that banks perhaps cannot process golf handicapping scores because it didn't deal with dollar amounts—they dealt with golf—and perhaps could not engage in doing nuclear reactor calculations, but there was very little else that the Federal Reserve Board, in regulation Y, did not feel was "closely related."

If the Federal Reserve Board was set up as referee, I would say that, unfortunately, they didn't draw the center line down the center of the court.

Senator MCINTYRE. That's an example, it seems to me, Mr. Chairman, of one thing that we fail to do here, and that is to oversee legislation that we pass. In conference, didn't we have a contest over the laundry list of the House and didn't we assemble right here and say it seems to use that the best place for this decision to be made is with the Federal Reserve Board?

Senator SPARKMAN. That's correct.

Senator MCINTYRE. I never knew the Comptroller got into the act.

Senator SPARKMAN. I didn't, either. Let me get clear in my own thinking. This was an action on the part of the Chase Manhattan Bank going of their own accord to the Comptroller. Is that right?

Mr. GOLDSTEIN. Yes, sir, and, Senator Sparkman, that's right that the House did pass a laundry list. I can understand your confusion in terms of a growing new field like data processing and not wanting to

put into legislation a laundry list, but I want to say when that laundry list—when that bag of laundry got to the Federal Reserve Board, it was pressed. It was all permitted. It wasn't even divided.

Senator MCINTYRE. I don't want to usurp the time of the chairman, but that was the problem. We were saying to ourselves, who am I to determine whether data processing—why don't we give it to the Board. And we were thinking of the long tenure of the Federal Reserve Board and we were thinking of the group—how many Federal Reserve Governors do we have—seven. I never could have conceived of the Comptroller, who I happen to have a great deal of respect for—that he was going to be the arbitrator. That's what I say. We're not doing enough oversight. I'm glad to say that our chairman now is doing that.

Mr. QUINN. May I add just one point to that? It is ironic because back in 1963 the then Comptroller of the Currency Saxton authorized this whole range of nonbanking activities and he was challenged in the court by the travel agents, by the insurance agents and data processing people, and in every single instance the court upheld the challenge and struck down the Comptroller's ruling as being invalid. When his successor, William Camp, came into office, he encouraged banks to form one-bank holding companies by his own admission, as Mr. McMullen's testimony states, as a device to avoid these court challenges. It was a loophole to encourage the banks to take advantage of them.

When the Congress closed the loophole in 1970 by giving the Federal Reserve Board additional power and responsibility it offered a degree of relief—but not sufficient relief in our view.

Ironically, what's now happening is that the banks are coming back to the Comptroller and using his very lax and very permissive regulation over banks to get back and do things that the Federal Reserve Board says is impermissible. That's happened in the travel field. The Federal Reserve Board held it's illegal for bank holding companies to operate travel agencies. Still, national banks are continued to allow to operate travel agencies because of the malfeasance of the Comptroller. So there's a gap and we think that enactment of S. 2721 and S. 2298 would close that.

Senator SPARKMAN. I simply want to say this. I was not aware that there was this conflict and I think it's a good thing that it's been called to our attention. I think the committee will give it most careful consideration, because it was our hope that we were getting away from loopholes. The House had its laundry list and finally we worked out this rule of reason about it being closely related, and setting up the Federal Reserve Board as the one to make the decision. I don't think any of us dreamed at the time that any conflict such as this would ever arise.

Mr. WESSEL. May I make a comment? This may be helpful because it relates to a specific meeting we had with a half dozen Federal Reserve Board staff. There are, of course two tests. One looks at the "benefit" test as well, once one gets past the issue of whether its "related." Applying the benefits test, after you assume there is a relationship, then the question is, is there a public benefit and what kind? We have been trying to assert as strongly as we could that if the activity

is going to be permitted, let's do it in a fair way. Let's not use an "edge." Let's have a different place of business. Don't even do it in the same territory you're giving credit in, and you won't have some of these problems of "tying effect" Mr. Goldstein is talking about. The Federal Reserve has been somewhat receptive to that. Some of their governors have made speeches saying they think this is a good concept. Why do you have to be in this territory? Go on out to another State where you haven't got the credit resource. And they have been, in some degree, sort of helpful.

When this Chase situation came along and we could do nothing at all with the Comptroller—at that point they were willing to answer a letter but that's about all—we went back to the Federal Reserve Board and we had a session with a number of the members of the staff. I don't have the names here but we have them in our file. And we said, "Look, we know the reason that they didn't come to you is because you're considerably more restrictive in this public benefits area. The Comptroller doesn't even give any consideration to it. Why can't you come in here and assert some authority?" And their answer was, "First of all, we really don't think we can overrule the Comptroller. We don't have that authority." But also—they sort of smiled, agreeing that a different kind of test is being applied by the Comptroller, and that they don't agree—at least these personnel do not agree with the way in which the Comptroller is allowing such an excess of market power to spill over from the banking line of commerce into all of these lines of commerce. Specifically we are talking about data processing. I guess that's the key problem. They know the power is there and I believe if you were to call some of the staff before this committee and ask them, "Do you apply a different test when you're considering whether something ought to go on terms of sheer market power concerns, purely antitrust principles"—maybe not as a matter of law, but as a matter of competitive principle, they would say, "Yes, we do apply a different test." The Comptroller doesn't even think about it.

Senator McINTYRE. Gentlemen, thank you. I want to, on behalf of the committee, extend our appreciation for your appearance here today and your testimony. As I said, I had other matters on my mind. We will try to take a look at this question. Certain things that popped up here today are surprising, so I hope somehow during the course of these hearings that justice will prevail and you will get the relief, if that's what you should have. Thank you all for your testimony.

[Whereupon, at 12:15 p.m., the hearing was adjourned.]

