Nonbanking activities of bank holding companies

Although bank holding companies (BHCs) have existed for over three-quarters of a century, their impact on the banking and financial sectors has become significant only in the past decade.[1] Prior to 1971 BHCs were divided into two basic types, multibank and one-bank holding companies. Multibank holding companies (MBHCs) were defined as corporate entities controlling at least 25 percent of the ownership of two or more banks and since 1956 have been required to register with the Board of Governors of the Federal Reserve System. Historically, MBHCs have been used largely to circumvent intrastate and interstate branch banking prohibitions, but in recent years they have been expanding into nonbanking areas.

One-bank holding companies (OBHCs), on the other hand, have had a more varied history. Originally, OBHCs were organized by families or individuals to control small banks while at the same time gaining certain tax advantages offered by incorporation. In other instances large nonfinancial holding companies would acquire a bank to facilitate the availability of banking services for their customers and employees. This latter type was frequently referred to as a "conglomerate" bank holding company [22, 25, 29].

About a decade ago, however, a distinct change occurred in the rationale behind the formation of OBHCs. This marked phenomenon was the bank-originated OBHC, whereby the holding company was formed at the initiative of the bank itself. By so doing, the bank holding company could diversify both the range of financial activities it could perform and the geographic area it served. Prior to the 1970 amendments to the Bank Holding Company Act of 1956, OBHCs were neither required to register with the Board nor were they subject to the act's restrictions. Many of the activities performed by OBHCs, though financial in nature, were activities prohibited both to banks per se and to

[1]The historical and legal development of bank holding companies has been traced in several articles in *Business Conditions* [22, 29, 30]. The banking aspects of multibank holding companies were surveyed in the December 1976 issue [9].

NOTE: Numbers in brackets [ ] refer to the numerically listed bibliography on pages 20-21. Citations are either to studies the results of which are described in this article or to scholarly elaborations of topics discussed.

registered (multibank) holding companies. The term "congeneric" has frequently been applied to this form of BHC [22, 25, 29].

The rapid growth of OBHCs and their tendency to acquire nonbanking business enterprises raised the spectre of the *Zaibatsu* (large multi-industry combinations common in Japan) dominating the American economy and threatening the traditional separation of banking from commerce. The logic of allowing banks to perform functions indirectly which they could not perform directly was questioned. In addition, the combination of banking with related nonbanking activities could produce anticompetitive effects. These concerns precipitated the inclusion of OBHCs into the act via the 1970 amendments, which restricted OBHCs to the same range of activities permitted MBHCs and also liberalized the criteria for determining the permissibility of new activities.

This article presents, in light of economic analysis and empirical evidence, the issues surrounding BHC entry into nonbanking activities. These issues include the permissible nonbanking activities, diversification, risk and the soundness of BHCs and the banking system, concentration and competition, operating efficiency, and pricing and profitability. Unfortunately, however, the empirical evidence available to decide the issues is scanty because (1) nearly all attention heretofore has been focused on the banking aspects of MBHCs; (2) the gathering and analyzing of data from affiliated nonbanking subsidiaries is extremely costly; and (3) data from nonbanking, nonaffiliated firms operating in nonbanking activities are very limited, thus making meaningful comparisons difficult.

Permissible activities

The list of permissible nonbanking activities for BHCs (see table) has increased only slightly during the last two years[2]—one new activity was approved, while five proposed activities were denied and two were placed "under consideration." There are apparently three reasons for the slackening. To begin with, the Board has adopted a "go slow" policy toward all BHC expansion, including both new activities and the acquiring of nonbanking firms engaged in activities already permissible. For example, the Board has denied applications to acquire mortgage guarantee insurance companies and firms underwriting and dealing in U.S. Government and certain municipal securities. Although all of these meet the criteria of being "closely related to banking" (see below), the Board apparently did not believe the time and circumstances were "right" for BHC entry.

In addition, it is conceivable that the list of permissible activities is close to being exhausted. To be exempt from prohibition, nonbanking activities must meet a two-part test. First, each activity must be "closely related to banking or managing or controlling banks." To qualify for exemption, one of the following connections must be made:

> 1) that banks generally have in fact provided the proposed service;
> 2) that banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed services;
> 3) that banks generally provide services that are so integrally related to the proposed services as to require their provision in a specialized form.[3]

Second, the activity must be "a proper incident" to banking and must pass a "net public benefits" test, requiring that the possible benefits to the public—greater convenience, increased competition, or efficiency gains accruing from the acquisition—outweigh possible adverse effects—increased concentration, decreased competition, or unsound banking practices. Since many of the activities clearly meeting both these criteria have already been approved by the Board, the

[2]The regulatory status of nonbank activities as of February 1975 is given in [30, pt. 1, pp. 3-6].

[3]*Federal Reserve Bulletin*, February, 1976, p. 149.

Status of bank holding company nonbanking activities under Section 4(c)(8)

(as of March 11, 1977)

Activities approved by the Board

1. Dealer in bankers' acceptances[2]
2. Mortgage banking[2]
3. Finance companies[2]
   a. consumer
   b. sales
   c. commercial
4. Credit card issuance[2]
5. Factoring company[2]
6. Industrial banking
7. Servicing loans[2]
8. Trust company[2]
9. Investment advising[2]
10. General economic information[2]
11. Portfolio investment advice[2]
12. Full payout leasing[2]
    a. personal property
    b. real property
13. Community welfare investments[2]
14. Bookkeeping & data processing services[2]
15. Insurance agent or broker—credit extensions[2]
16. Underwriting credit life & credit accident & health insurance
17. Courier service[2]
18. Management consulting to nonaffiliate banks[2]
19. Issuance of travelers checks[2]
20. Bullion broker[2]
21. Land escrow services[1,2]
22. Issuing money orders and variable denominated payment instruments[1,2,4]

Activities denied by the Board

1. Equity funding (combined sale of mutual funds & insurance)
2. Underwriting general life insurance
3. Real estate brokerage[2]
4. Land development
5. Real estate syndication
6. General management consulting
7. Property management
8. Nonfull-payout leasing[1]
9. Commodity trading[1]
10. Issuance and sale of short-term debt obligations ("thrift notes")[1]
11. Travel agency[1,2]
12. Savings and loan associations[1]

Activities pending before the Board

1. Armored car services[2]
2. Underwriting mortgage guarantee insurance[3]
3. Underwriting & dealing in U.S. Government and certain municipal securities[2,3]
4. Underwriting the deductible part of bankers' blanket bond insurance (withdrawn)[1]
5. Management consulting to nonaffiliated, depository type, financial institutions[1,2]

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[1]Added to list since January 1, 1975.

[2]Activities permissible to national banks.

[3]These were found to be "closely related to banking" but the proposed acquisitions were denied by the Board of Governors as part of its "go slow" policy.

[4]To be decided on a case-by-case basis.

number of future additions to the list of permissible activities is likely to be small. In February the Board determined that the ownership of savings and loan associations by BHCs is not a permissable activity. Although considered "closely related to banking," in the Board's view the potential adverse effects of affiliation with banking outweigh the potential benefits.

Lastly, the adverse economic conditions during the 1973-75 period caused serious financial problems for some BHCs resulting in the fall of BHC stock prices and contributing to the Board's "go slow" policy. Many BHCs have been reluctant to push for either new activities or new acquisitions, which has been reflected by a considerable reduction in BHC applications of both types being submitted to the Board in recent years. However, as economic conditions improve, this trend is likely to be reversed [26].

The Board has been criticized by some for being too permissive with respect to the activities BHCs are allowed to perform, while it has been criticized by others for being too restrictive. Clearly, both criticisms cannot simultaneously be correct, and they serve to highlight certain problems faced by the Board in ruling on proposed activities.

First, the words "closely related to banking" in Section 4(c)(8) of the act are extremely vague. Essentially, the interpretation was left up to the Board, subject to judicial review. To some degree the Board may feel constrained by what it believes the courts will accept.

Second, it appears that the Board, in making its determinations on activities, considers those activities which are permissible for national banks. With a few exceptions the permissible activities for bank holding companies and national banks are nearly identical (see table). Thus the range of activities BHCs may perform is not very different from that of many banks.

Two other facets of the controversy over the nonbanking activities of BHCs should be noted. While the list of permissible activities is impressive, BHC entry by acquisition has been predominantly limited to three areas: consumer and commercial finance, mortgage banking, and insurance (underwriting and broker or agency) [26]. De novo entry has, by and large, been limited to these three plus leasing and advisory services. Intuitively, these activities seem to afford the greatest opportunity for the application of banking expertise.

Given the controversy surrounding the importance and range of nonbanking activities, one would expect that these activities constitute a relatively significant proportion of the BHC organization. Quite the contrary is true, however. Currently, nonbanking subsidiaries account for less than 5 percent of the total consolidated assets of BHCs [8, 32] and about 3 percent of the assets of the largest 50 BHCs [33].

Risk, soundness, and BHCs

Perhaps the most important and controversial current issue regarding entry of BHCs into nonbank activities has been the impact of such expansion and diversification upon the integrity and soundness of affiliate banks, the holding company, and the banking system. Although BHCs entered nonbanking areas en masse following the 1970 amendments, entry into these activities has subsided while the controversy has continued.

Proponents of BHC expansion argue that through acquisition of nonbank subsidiaries, the overall level of risk for a given level of return can be lowered, thereby strengthening the BHC and, consequently, the banking system. Performance of nonbank activities allows a BHC to diversify both by activity and by geographic market area, especially since nonbank activities may be performed across state lines. Ever since the advent of multiproduct and multimarket firms, the logic of diversification has been employed by firms in nonregulated industries to stabilize the profitability of the total organization by insulating it from seasonal or cyclical variations affecting the organization's component divisions.

Opponents of BHC expansion question whether entry into nonbank activities has actually stabilized the banking industry by reducing risk per dollar of investment. They also raise issues regarding permissible types of risks for BHCs.

The spectrum of alternatives ranges from permitting BHCs to engage in no activity riskier than traditional banking services to allowing BHCs to undertake activities considered much riskier than the basic functions of banking. The Board's position on BHC activities appears to be about midway between these two extremes.

The assessment of risks differs among depositors, managers, owners, and regulators. The Board, however, must view the riskiness of nonbank activities within the context of safety for the entire banking system, a constraint not imposed by the other groups. That is, the Board must consider the riskiness of each activity with respect to the bank affiliate and ultimately upon the banking system, whereas the other groups view the bank affiliate as one of several activities to be performed by the enterprise.

Economists and financial analysts disagree over methods for quantifying risk, giving rise to many views regarding the identification and objective measurement of various risks. Consequently, the relationship between diversification and risk and the resultant impacts on the soundness of individual BHCs and the entire banking system is difficult to assess.

Risk is essentially the lack of perfect knowledge in making decisions. A relevant measure of BHC performance is the mean, or average, rate of return either on assets or equity capital. A frequently used, but not universally accepted, statistical measure of risk is the standard deviation (or variance) of the rate of return, which shows the dispersion (variation) of the profit rate about its average value.

Two principal views exist regarding the relationship of risk, diversification, and permissible BHC activities. One view holds that risk, measured by the standard deviation or variance of the rate of return alone, is a sufficient criterion for determining the desirability of entering nonbank activities. Any activity having a greater variance in its rate of return than banking is defined as being riskier than banking, and some analysts extend this to say these should not be permissible activities. A second view holds that variance alone is not a sufficient criterion. Rather, the proper criterion in evaluating activities should be risk relative to the expected, or average, return, although some upper limit to the amount of risk appropriate for BHCs to assume is probably implicit.

In combining two activities, risk becomes a function not only of the individual variances, but also of the degree of correlation between the profit rates of the activities. If the profit rate of two activities exhibits negative correlation, the variance of the combined profit rate, and thus the risk, will be lower than each activity taken alone. If the activities are positively correlated, the advantages of diversification may still exist. Combining activities having positive correlation between the rates of return may possibly increase the total risk but reduce the risk relative to the total level of production. The return to the BHC, as with any investment portfolio, is likely to be more stable the wider the range of activities (industry securities) held. In general, firms in the same industry are more likely to do poorly at the same time than are firms in unrelated industries.

An interesting situation arises regarding those activities that pass the "closely related to banking" test of Section 4(c)(8) of the act. The more closely related the nonbank activity is to banking, the more likely there will be a positive correlation between the profits of that activity and banking, and the smaller the advantages arising from the diversification principles. BHCs can, therefore, reduce their relative risk exposure most by expanding into the nonbank areas most remote from banking (unless earnings variances are a great deal higher than in banking). From 1956-70 only one activity—banking—was explicitly permitted bank holding companies by the act, and little exercise of the diversification motive was open to BHCs.

The justification for diversification is not solely restricted to the expected reduction in the variation of profits. Diversification also helps mitigate uncertainty; in particular, by lessening a BHC's dependence on one activity, it reduces the potential losses if that activity were to become obsolete or unnecessary.

Before we can make any assessment of the impact diversification has had upon the soundness of the banking system, we must know the risk levels associated with each of the nonbanking activities BHCs are likely to enter, as well as the degree of correlation between their profits and profits in banking.[4]

Because nonbanking activities are required to be "closely related to banking," one might expect the correlation between the profits of banking and several of the nonbanking activities to be positive since they would be subject to common influences. While limited empirical evidence exists on this issue, one study indicates that the profits of several permissible nonbank activities are *negatively* correlated with bank profits, suggesting that it is possible to significantly reduce a BHC's level of overall risk by diversifying into these activities [14]. For example, the returns in insurance and real estate financing tend to be high when returns in banking are low. On the other hand, the profitability of other nonbank activities—such as business credit, consumer credit, and loan servicing—exhibits a positive correlation with bank profits. The different leasing functions have mixed correlations. These correlations are based upon the profits of each industry and are predicated on the activities being performed independently. Once banking is combined with another activity under the same corporate umbrella, these correlations may no longer hold.

With respect to measuring the degree of risk in various activities, the evidence is somewhat contradictory. One study, measuring risk by the coefficient of variation of industry profit rates (the standard deviation of the profit rate divided by the average profit rate), found banking to be one of the most risky activities that BHCs are allowed to perform [14]. Another study, measuring risk by the standard deviation in the monthly rate of return on the common stock of firms in various industries over the 1961-68 period, found banking to be the least risky of the activities considered [11]. While both studies have shortcomings, the latter was characterized by a very small sample size (e.g., only 19 banks, two mortgage banking firms, one insurance company). Moreover, the return (and standard deviation) was computed on a monthly basis, which would seem to be meaningful only from the viewpoint of the small investor. The actual annual profits of the firm—an item of major interest to managers, controlling owners, and regulators in assessing risk—were ignored in the study.

Thus, empirical evidence currently is not sufficient to judge which nonbanking activities, taken in isolation, are more risky than banking and which are less risky; nor is it adequate to identify those activities having the greatest stabilizing effect on holding company profits.

While the variation in and correlation of profits are important concerns in dealing with soundness, they are not the only concerns. Another is the problem of capitalization, both of the BHC and of the nonbank affiliate. The question has been raised whether parent holding companies tend to be undercapitalized [5, 21, 34], and there is some evidence to indicate that they are [21]. Also, some evidence suggests that BHC nonbank affiliates in consumer finance and mortgage banking have lower equity capital-to-total asset ratios than the respective industry standards [35] (referred to as leverage, but this is only one of several possible definitions in use). Whether BHC nonbank subsidiaries in other activities are more highly leveraged than their nonaffiliated competitors is not known. Furthermore, the statistical methodology is somewhat faulty in that no effort was made to measure each firm's leverage ratio prior to acquisition. It is conceivable that the preacquisition leverage was also higher than the industry standards.

[4] Industrial firms practicing diversification have not enjoyed unequivocal success. Diversification *per se* may not have been the cause of this lack of success, however, since too rapid growth and expansion, undercapitalization, and adverse economic conditions may also have contributed to their lackluster performance.

In the final analysis, however, a more preferable method of evaluating the soundness of the banking system might be to simultaneously examine the mean and variance of earnings *and* the capital structure [36]. While this approach seems intuitively appealing, most studies have focused on one or the other.

Other factors play important roles in determining the soundness of the banking and financial sectors. For example, the soundness of any business entity depends upon the degree to which it is legally insulated from the other bank or nonbank companies with which it is affiliated. Soundness also depends upon the degree to which BHCs provide their affiliates with financial and managerial resources, thereby strengthening the affiliates. By instituting more aggressiveness and risk into the operating policies of affiliates or introducing intersubsidiary transactions having the eventual effect of weakening the bank or other affiliates, BHCs could significantly weaken themselves and the banking and financial sectors. These considerations are important, but at the present time we have little knowledge of their extent and impact.

In sum, it appears at this time that we are a long way from having any definite knowledge of the impact of the nonbank activities of BHCs upon the soundness of the banking and financial sectors. The partial evidence which is available provides tenuous answers at best. As a final thought, it should be noted that even if entry into the nonbank activities were to reduce the risk of failure for the BHC, the external social cost of failure will very likely rise because as the organization becomes larger, the absolute cost of failure both to the organization and to the financial system also becomes greater [5]. Therefore, the net effect depends on what happens to the "expected cost" of failure, obtained by multiplying the increased cost of failure by the reduced probability of occurrence.

But, to the extent that nonbank expansion is a substitute, rather than a complement, to bank expansion, the overall size of BHCs need not increase.

Concentration and competition

After the 1970 amendments were passed, BHCs moved rapidly into many of the permissible nonbanking areas, creating concern about the impact this expansion would have upon the concentration of economic resources.[5] One of the primary factors the Board is required to consider under Section 4(c)(8) of the act is the prevention of "an undue concentration of resources." Typically, concentration is discussed at three levels: aggregate or nationwide concentration, statewide concentration, and local or market concentration. Unfortunately, comment on the effects of nonbanking activities upon statewide concentration is not possible at this time because no work has been done in the area.

Aggregate concentration. Since BHCs participate in banking as well as nonbanking (but closely related to banking) activities, the phrase "concentration of resources" must refer to financial resources. Between 1966 and 1973 the share of total financial assets held by the largest 100 BHCs increased from 16 percent to 29 percent [33].[6] While this increase is substantial, it is questionable whether a 29 percent share accounted for by the largest 100 firms constitutes undue concentration by the standards of most U.S. "industries." It should be kept in mind, however, that BHC entry into the nonbanking areas has not been uniform across activities.

On the other hand, it does not appear that BHC entry into nonbanking activities, per se, has been a major contributor to this increase in aggregate concentration. The Board has limited entry into these activities largely to either de novo or foothold entry; as a result, nonbank assets account for less than 5 percent of consolidated holding company assets for all U.S. BHCs and only 3 percent for the largest 50 BHCs. While the amount of assets

[5]For a fuller conceptual discussion of concentration and competition, see [9].

[6]Excluding foreign branch assets, however, the figures are 15 percent and 24 percent, respectively. The largest relative increase has thus been in this category.

held in nonbank activities has been growing, it does not explain the 13 percentage point increase in the share of financial assets held by the 100 largest BHCs. Rather, this change appears to be more likely a result of the increased use by large banks of nondeposit sources of funds to finance asset growth.

Local (market) concentration. Market concentration is, by far, the most important measure of concentration because it is most closely associated with the degree of competition in a local area [9]. While there is no direct evidence on this issue with respect to nonbank activities, it may be possible to get some insight into the future by looking at the Board's policies related to permissible forms of entry into nonbank activities.

The Board seems to be following a two-part policy regarding BHC entry into the nonbanking areas. First, the acquisition of large firms (i.e., firms having a large share of the market) is discouraged [17]. Second, entry into new markets by either de novo or foothold means is encouraged. In particular, the Board has made de novo entry administratively much simpler than the acquisition of a going concern. De novo entry has been emphasized because it adds a new decision maker to the market and increases the number of competing firms, thereby raising the likelihood that BHC entry will have a procompetitive effect. De novo entry would probably be less prevalent in the absence of the act and the Board's enforcement policies.

With regard to credit services it is possible that BHC activity has improved the allocation of financial resources. Being able to expand geographically, especially interstate, has allowed BHCs to compete over a wider area, and thereby offer credit in locations where the demand is greatest.

At the same time, however, the magnitude of mortgage lending has apparently not been affected by BHC affiliation. Preliminary evidence indicates affiliated mortgage banks grow no faster than nonaffiliated mortgage banks, while commercial banks neither increase nor decrease their mortgage lending activity upon affiliation with a mortgage bank [27].

Operating efficiency

Improved operating efficiency for nonbank firms is a commonly cited benefit of affiliation with a bank holding company. That is, through affiliation, the nonbank firm can potentially achieve some cost reductions through the parent holding company's ability to generate new business for the nonbank affiliate, thus increasing the affiliate's level of output. If the affiliate is operating on the downward sloping portion of its average cost curve, this increase in ouput could then be translated into lower unit cost. The public would benefit if and when this lower unit cost is passed on in the form of lower charges. Even if they are not passed on, lower operating costs would increase the profitability of the bank holding company, thus enhancing the strength of the banking and financial systems.

A second source of potential cost savings arises from economies of affiliation, which could result if some of the functions previously performed by the independent firm were centralized at the BHC level or if the purchase of some inputs was centralized. For example, since the parent company may have greater access to the capital market, it may be able to acquire capital funds for the affiliate at a lower rate than an independent firm of equal size could obtain.

While these arguments have intuitive appeal, at the present time there is no evidence to support them. No systematic effort has been made to study empirically the impact of BHC affiliation upon the operating costs of nonbanking firms. On the other hand, studies examining the impact of affiliation upon banking firms indicate that affiliated banks, for some reasons, have higher costs than independent banks [9]. While the exact causes of this phenomenon have not been determined, one possible reason is that affiliate banks are subject to higher charges from the nonbank subsidiaries or the parent holding company [9]. A definitive judgment cannot be made at this time as to the impact of affiliation upon the operating efficiency of firms engaged in nonbanking activities; more work needs to be done in this area.

Pricing and profitability

Pricing. In the eyes of the Board public benefits arise from BHC performance of nonbank activities when affiliates charge lower prices for any given service than their nonaffiliated competitors. Empirical evidence on this issue is sparse and provides little insight. The only nonbanking activity about which there is any evidence is insurance underwriting. Regulation Y stipulates that BHCs cannot underwrite credit life, accident, or health insurance unless the premiums charged are less than the ceiling rates established by the state. According to a recent study analyzing the results of this policy, rates charged by BHC affiliates in 1974 resulted in approximately a 13 percent savings in premiums [28].

Profitability. Because of the lack of information concerning either the operating efficiency or pricing of nonbank affiliates, the impact of affiliation on the profitability of nonbank companies cannot be predicted. However, a recent study covering 1973 and 1974 indicates that the rates of return on invested capital in two of the more popular nonbank activities—mortgage banking and consumer finance—are considerably lower for BHC affiliates than for each respective industry as a whole [35]. There are at least three reasons for this occurrence. First, because of their comparatively recent entry into these activities, BHC affiliates could be charging lower prices in an effort to attract customers from their longer-established competitors; second, affiliates could be incurring higher costs; or third, affiliates could be carrying higher levels of invested capital than the average firm in the industry (which contradicts Talley's study). Some combination of the three is also possible. At the present time, however, which influences may predominate is not ascertainable. Additionally, because the profitability of these firms prior to affiliation is not known, their lower rates of return may not be due to affiliation.

Summary

Nonbanking activities of BHCs are a hotly contested issue which will become even more heated in the future. To draw any definitive conclusions, based on evidence available at this time, about the efficacy of BHC entry into the nonbanking areas and the resultant impact on the financial system would be overstepping the bounds of credibility. Evidence to support any conclusions is lacking both in quantity and quality, and unfortunately, if historical experience is a guide, probably half a decade will pass before we are in a position to make a more definitive declaration.

Dale S. Drum

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