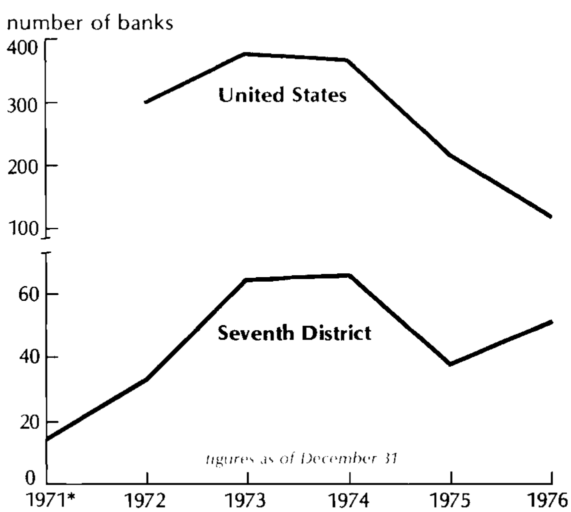
# Banking insights

## *District holding company acquisitions on the rise*

Holding company acquisitions of commercial banks in the states comprising the Seventh Federal Reserve District returned to an upward trend during 1976. The renewed activity followed a peak in 1974 and a slowdown in 1975. Nationwide, holding companies did not follow the District trend, as the absolute number of commercial banks acquired by holding companies during 1976 shrank for the third consecutive year.

Although nearly 44 percent of all banks acquired by holding companies in 1976 were located in the Seventh District, the District accounted for less than its share of banks affiliated with holding companies at year end. Holding companies controlled approximately 26 percent of all commercial banks across the nation by the end of 1976, but only 22 percent within the five District states.

### Holding company acquisitions in the District rebounded, but continued downward in the nation




*Comparable U.S. data for 1971 not available.

### Multibank holding companies

Multibank holding companies are becoming increasingly important in the structure of District banking. In Michigan, after only five years of rapid expansion, bank subsidiaries of these companies control nearly two-thirds of the state's commercial bank deposits.[1] Multibank holding companies have been legal in Wisconsin for many years and are on the verge of holding more than half of the state's deposits. Multibank holding companies and one-bank holding companies are of about equal importance in Iowa, with multibank holding companies controlling approximately 25 percent of the state's deposits and one-bank companies controlling about 23 percent. Although Illinois and Indiana banking laws prohibit the formation of multibank holding companies, one "grandfathered" multibank holding company and 40 *de facto* multibank holding companies operate in Illinois.[2]

### Nonbanking activities

Almost 40 percent of the District holding company organizations were engaged in nonbanking activities at year-end 1976. Under the regulations of the Bank Holding Company Act, a bank holding company can engage in certain nonbanking activities that are closely related to banking, such as leasing, insurance, and real estate; certain activities—such as advertising, exterminating, and issuing

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[1]Michigan law prohibited Michigan corporations from owning bank stock until April 1971.

[2]For a discussion of *de facto* multibank holding company activity in the District, see Joseph T. Keating, "Chain banking in the District," *Economic Perspectives*, September/October 1977.

**Bank holding companies in the Seventh District**
*(December 31, 1976)*

| | Multibank holding companies: Number of MBHCs* | Number of subsidiary banks | Total MBHC deposits | Share of total banks | Share of total deposits |
|---|---|---|---|---|---|
| | | | (millions) | (percent) | |
| Illinois | 1 | 3 | $ 151.1 | 0.2 | 0.2 |
| Indiana | — | — | — | — | — |
| Iowa | 10 | 65 | $ 3,272.3 | 9.9 | 25.1 |
| Michigan | 24 | 108 | $ 20,480.2 | 30.0 | 64.5 |
| Wisconsin | 19 | 121 | $ 6,679.8 | 19.3 | 40.4 |
| Five-state total | 54 | 297 | $ 30,583.4 | 9.0 | 21.2 |
| United States | 298 | 2,295 | $286,514.0 | 15.6 | 34.2 |

| | One-bank holding companies: Number of OBHCs* | Number of subsidiary banks | Total OBHC deposits | Share of total banks | Share of total deposits |
|---|---|---|---|---|---|
| | | | (millions) | (percent) | |
| Illinois | 171 | 171 | $ 34,796.5 | 13.7 | 55.1 |
| Indiana | 30 | 30 | $ 6,393.8 | 7.3 | 32.3 |
| Iowa | 146 | 146 | $ 2,955.4 | 22.2 | 22.6 |
| Michigan | 20 | 20 | $ 2,405.2 | 5.6 | 7.6 |
| Wisconsin | 47 | 47 | $ 1,143.4 | 7.5 | 6.9 |
| Five-state total | 414 | 414 | $ 47,694.3 | 12.5 | 33.1 |
| United States | 1,504 | 1,496 | $267,135.0 | 10.2 | 31.9 |

*Holding companies that were subsidiaries of other holding companies were eliminated, but holding companies whose bank subsidiary was also a subsidiary of another totally unrelated holding company were included.

NOTE: Data for entire state, not only the portion within the Seventh Federal Reserve District.

**Distribution by deposit size of District banks affiliated with OBHCs and MBHCs**
*(December 31, 1976)*

| Bank deposit size | OBHCs: Number of subsidiary banks | MBHCs: Number of subsidiary banks | Total commercial banks in five District states |
|---|---|---|---|
| *(million dollars)* | | | |
| Under $9.9 | 78 | 49 | 1,026 |
| $10 to $24.9 | 136 | 94 | 1,179 |
| $25 to $49.9 | 87 | 69 | 607 |
| $50 to $199.9 | 86 | 63 | 427 |
| $200 to $499.9 | 17 | 12 | 43 |
| $500 to $999.9 | 3 | 5 | 10 |
| $1,000 to $2,999.9 | 4 | 4 | 8 |
| $3,000 or more | 3 | 1 | 4 |
| All size banks | 414 | 297 | 3,304 |

NOTE: Data for all banks in the five District states, not only the portion within the Seventh Federal Reserve District.

trading stamps—are permitted if the holding company had been engaged in them prior to 1968. The District's multibank holding companies have been much more active in the nonbanking fields than have their one-bank counterparts. Eighty-five percent of the District's multibank holding companies and 34 percent of the District's one-bank holding companies had diversified and expanded their operations to nonbanking activities by the end of 1976.

## Prospects for future holding company developments

Iowa, Michigan, and Wisconsin allow multibank holding companies and the share of total banks affiliated with holding companies in these three states is very close to or above the national average. Yet these states contain over 1,100 commercial banks that remained unaffiliated with a holding company at the beginning of 1977. As a potential source of expansion, these banks could be acquired by one-bank holding companies to form multibank holding companies.

In Illinois and Indiana the share of banks controlled by holding companies is far below the national average. Increasing these proportions would seem to depend on changing Illinois and Indiana banking laws to allow multibank holding companies to operate within these two District states. Although several proposals to permit multibank holding companies have been introduced in both states in recent years, they have fallen far short of attracting the support needed for adoption.

Another prospect for holding

### Nonbanking activities of Seventh District and U.S. bank holding companies

| | Seventh District | | | United States |
|---|---|---|---|---|
| **Industry Group Title** | **Number of OBHCs** | **Number of MBHCs** | **Share of all bank holding companies** | **Share of all bank holding companies** |
| Leasing activities | 66 | 29 | 21.3 | 23.7 |
| Insurance underwriting and service | 83 | 12 | 21.3 | 25.7 |
| Real estate | 37 | 11 | 10.7 | 13.4 |
| Commercial credit institutions | 32 | 13 | 10.1 | 16.7 |
| Establishments performing functions closely related to banking | 32 | 5 | 8.3 | 5.7 |
| Data processing | 22 | 11 | 7.4 | 12.2 |
| Mortgage banking | 17 | 14 | 6.9 | 14.1 |
| Miscellaneous business services | 26 | 5 | 6.9 | 7.4 |
| Consumer credit institutions | 16 | 3 | 4.3 | 7.7 |
| Trust services | 9 | 4 | 2.9 | 2.2 |
| Investment advisors | 5 | 6 | 2.5 | 4.2 |
| Loan servicing | 5 | 3 | 1.8 | 1.8 |
| Investment companies | 6 | 1 | 1.6 | 4.0 |
| Holding companies—except bank holding companies | 4 | 1 | 1.1 | 3.9 |
| Securities underwriting and exchange services | 2 | 3 | 1.1 | 2.6 |
| Management consulting | 3 | — | 0.7 | 3.2 |
| Savings and loan associations | 2 | — | 0.4 | 0.8 |
| Credit card services | 1 | 1 | 0.4 | 0.7 |
| Industrial banks | — | 1 | 0.2 | 1.0 |
| Economic advisors | 1 | — | 0.2 | 0.5 |
| Courier services | 1 | — | 0.2 | 0.3 |

NOTE: This data includes all direct and indirect subsidiaries of bank holding companies, and Seventh District data pertains only to banks and holding companies operating within the Seventh Federal Reserve District.

company activity depends largely upon the intentions of the over 250 one-bank holding companies in the District that have not exercised options to diversify into the permissible nonbanking fields.

*Joseph T. Keating*

# Deposit service charges

Service charges collected on average demand deposits have increased over the past few years. According to the Reports of Condition and Income, service charges collected relative to average demand deposits of individuals and businesses generally reached a low during 1972 and 1973 both nationally and in the Seventh District. The reason for the recent increase is not precisely known. Lower earnings rates on loans and securities have no doubt reduced the portfolio income earned by commercial banks. At the same time higher processing costs may have generated pressure for the recovery of additional check administration costs. Discussion of more explicit pricing for services may have already stimulated implementation of more specific charges.

Service charges recover only a small portion of the costs of administering checking accounts. The difference between the amounts collected and the actual costs is an implicit return to the account holder. Proposals to permit commercial banks to pay interest on demand deposits or to offer interest-bearing negotiable order of withdrawal (NOW) accounts for transaction purposes would allow for the substitution of an explicit interest payment for all or most of the present implicit return. Banks would probably find it necessary to unbundle packages of services available to depositors and to price each of these services more in accordance with its costs. Total service charges could be expected to generally increase, although the amount would vary among banks.

Comparison of aggregative data for various structural groupings of banks shows that the ratio of total service charges to average demand deposits varies significantly.[1]

[1]The ratios used in this article are based on service charges (Report of Income: A1d) ÷ Average IPC demand deposits (Report of Condition: F(A)1c).

An important factor that may affect all such comparisons is the proportion of deposits in personal accounts. The service charge ratio is higher at banks with deposits less than $500 million than at those with deposits above this amount, no doubt reflecting the larger proportion of consumer demand deposits at the smaller banks. Within the same size groupings, total service charge income was lower in relation to total deposits at banks that are members of the Federal Reserve System than at nonmembers and lower at Seventh District banks than nationally.

### Personal vs. business accounts

Service charges are substantially higher on personal checking accounts than on commercial checking accounts. According to data submitted by participants in the Functional Cost Analysis (FCA) program run by the Federal Reserve System, service charges as a percent of demand deposit balances, nationally, were five times larger for personal checking accounts than for business accounts at banks with deposits below $200 million. At bigger banks they were eight times larger.

The higher service charges on consumer demand deposits reflect the higher administrative expenses per dollar volume associated with individual checking accounts than with business checking accounts. Most of the difference is attributable to the much smaller average size of the personal checking account. In 1976 the average commercial checking account was eight times larger than the average personal checking account of $874 at banks with less than $50 million in deposits and up to 13 times larger than the average personal checking account of $947 at banks with deposits of $200 million or more.

The multi-service relationship of banks with business helps to explain the larger average size for commercial checking accounts. Larger minimum balances may be required for transaction services, and compensating balances are frequently required for business loans. These balances are to a large extent in lieu of service charges.

Despite the higher service charges on personal checking accounts, according to FCA studies, service charges recover only about one-fifth to one-fourth of administrative expenses of the accounts. For business accounts the proportion ranges from one-eighth to one-fifth. Generally, smaller banks recover a larger proportion of the total expense in service charges for each type of account.

The difference between the expense to the bank of a checking account and service charges is implicit interest on the deposit for the account owner. Because of the substantially higher administrative costs for personal checking accounts, the implicit interest is also much higher than for business checking accounts. Businesses may, however, receive other benefits, especially where some of the business demand deposits represents the compensating balance for a loan at a lower rate than would be required without a compensating balance. Because business balances pay for so many other bank services, the connection between business checking costs and deposit service charges is more variable for business accounts.

**Large vs. small banks**

The ratio of total service charges to average demand deposits varies significantly by bank size. Nationally, in 1976 the ratio ranged from a low of .56 percent for banks with $500 million and over in deposits up to .92 percent for banks with $25 million to $50 million in deposits.

Most of the variation in service charges relative to demand deposits probably reflects the lower proportion of consumer demand deposits at the larger banks than at the smaller banks. According to the FCA data, participating banks with $500 million and over in deposits in 1976 reported only 25 percent of demand deposits in personal accounts, while banks with less than $50 million in deposits had 41 percent.

Federal Reserve Board surveys of demand deposit ownership confirm the smaller proportion of demand deposits owned by consumers at the large banks. As of the June 1977 survey, 22 percent of demand deposits for the large bank reporting panel were in consumer accounts compared with 41 percent at the smaller banks.

**Member vs. nonmember**

Total service charges relative to average demand deposits were lower for banks that were members of the Federal Reserve System than for banks that were not. This was true both nationally and in the Seventh District. Only for small banks with deposits of less than $10 million in 1976 is the comparison ambiguous.

Cost information that might indicate the reason for relatively lower service charges at member banks is not available since nonmember banks have not participated in the FCA studies. Ownership of demand deposits probably does not vary significantly between member and nonmember banks of similar size.

The difference in service charges is more pronounced for banks with $100 million or more in deposits than for smaller banks. A possible explanation is that member banks, for whom the Federal Reserve provides check processing, are passing the savings on to consumers through lower service charges.

A recent survey by the Federal Reserve Bank of St. Louis indicated that small member banks make relatively little use of Federal Reserve check clearing services.[2] This may explain the absence of a significant difference in service charges between small member and nonmember banks.

Previous studies that have compared service charge income relative to demand

[2]Gilbert, R. Alton, "Utilization of Federal Reserve Bank Services by Member Banks: Implications for the Costs and Benefits of Membership," *Review*, 59: 2-15, August, 1977, Federal Reserve Bank of St. Louis.

## Service charge income relative to checking balances varies . . .

### . . . by size and membership status

| Deposit size | United States Member | United States Nonmember | Seventh District Member | Seventh District Nonmember |
|---|---|---|---|---|
| Less than $5 million | .88 | .72 | .42 | .43 |
| $5-10 million | .89 | .89 | .64 | .56 |
| $10-25 million | .85 | .94 | .66 | .70 |
| $25-50 million | .83 | 1.01 | .75 | .78 |
| $50-100 million | .79 | .87 | .71 | .74 |
| $100-500 million | .69 | .87 | .59 | .79 |
| $500 million and over | .55 | .64 | .45 | — |

### . . . by state

Member banks in 1976

| Deposit size | Illinois | Indiana | Iowa | Michigan | Wisconsin |
|---|---|---|---|---|---|
| Less than $5 million | .30 | .28 | .45 | 1.34 | .59 |
| $5-10 million | .42 | .35 | .45 | .87 | 1.04 |
| $10-25 million | .46 | .58 | .54 | 1.00 | .77 |
| $25-50 million | .70 | .50 | .74 | .91 | .55 |
| $50-100 million | .62 | .75 | .64 | 1.10 | .49 |
| $100-500 million | .46 | .73 | .33 | .99 | .36 |
| $500 million and over | .24 | .86 | — | .71 | .38 |

### . . . and over time

U.S. member banks

| Year | Deposit size: Less than $5 million | $5-10 million | $10-25 million | $25-50 million | $50-100 million | $100-500 million | $500 million and over |
|---|---|---|---|---|---|---|---|
| 1970 | .72 | .91 | .95 | .91 | .79 | .71 | .48 |
| 1971 | .66 | .91 | .94 | .89 | .78 | .69 | .49 |
| 1972 | .65 | .81 | .87 | .83 | .76 | .65 | .47 |
| 1973 | .61 | .72 | .82 | .81 | .75 | .64 | .49 |
| 1974 | .73 | .74 | .82 | .81 | .76 | .68 | .51 |
| 1975 | .94 | .80 | .85 | .85 | .77 | .68 | .53 |
| 1976 | .88 | .89 | .85 | .83 | .79 | .69 | .55 |

SOURCES: Report of Condition and Report of Income.

deposits for member vs. nonmember banks have analyzed data for the small banks, primarily those with less than $10 million in deposits.[3] The comparisons presented here suggest a need for further analysis of the data for larger banks, especially those with deposits of over $100 million that make extensive use of the Federal Reserve check processing services available to members.

### Variation within the District

Among Seventh District states the ratios of service charges to demand deposits for member banks are significantly higher in Michigan than in the other states. This may reflect either fewer banks with more branches, a higher proportion of consumer accounts, or more explicit pricing of checking account services.

Results in other states are mixed, although Illinois member banks, Indiana banks with less than $50 million in deposits, and Wisconsin banks with over $50 million in deposits do appear generally to have lower relative service charges. The largest Illinois member banks, which includes the big Chicago banks with a high proportion of business accounts, have the lowest aggregate ratio.

### Trend reversed

In the current decade service charges relative to demand deposits reached a low in 1973 for banks with total deposits of less than $500 million and in 1972 for larger banks. The overall trend does not appear much affected by changes in the distribution of demand deposits between personal and business accounts. At the large banks that report in the demand deposit ownership survey the proportion of demand deposits owned by consumers increased slightly over the past four years and the fraction owned by nonfinancial businesses changed little. At smaller banks the proportions were essentially unchanged.

Strong business loan demand during 1972 and 1973 led commercial banks to compete aggressively for deposits as a source of loanable funds. For many banks this entailed the reduction of service charges and offers of "free" checking. Service charges were primarily to control excessive use of checking services.

Service charges have risen again since 1973. Declining interest rates, reduced demand for business credits, and rising provisions for loan losses necessitated closer control of expenses. As the return on loans declined, a larger portion of the checking account costs has had to be recovered through service charges to maintain net earnings.

### New competitive strategy

The marketing strategy of commercial banks to obtain demand deposits has been to emphasize low or nonexistent service charges for checking convenience. The Banking Act of 1933 prohibited banks from paying interest on demand deposits. Rising interest rates permitted a larger portion of check processing costs to be absorbed by portfolio earnings. Service charges were primarily to provide an incentive to customers to economize on the use of checking account services.

It seems likely that the payment of explicit interest on demand-type deposits would shift emphasis to interest rates offered and competitive prices for services. Depositors could select on a more rational basis the services needed combined with the highest interest rate available on a required minimum deposit. The net result could be an increase in the amount of demand deposits and reduced utilization of checking services. Service charges would doubtless increase but probably not to the present cost of service as depositors economize on costly services that are currently "free."

*Eleanor Erdevig*

[3]Fraser, D.R., Rose, P.S., and Schugart, G.L., "Federal Reserve Membership and Bank Performance: The Evidence from Texas," *Journal of Finance*, May 1975, 641-658; Gilbert, G.G., and Peterson, M.O., "The Impact of Changes in Federal Reserve Membership on Commercial Bank Performance," *Journal of Finance*, June 1975, 713-719, and Varvel, W.A., "The Cost of Membership in the Federal Reserve System," Working Paper No. 77-1, Federal Reserve Bank of Richmond, March 1977.