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by Bank Holding Companies**

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# THE RATIONALE FOR ACQUISITION OF FINANCE COMPANIES BY BANK HOLDING COMPANIES

Robert W. Johnson\*

## The Scope of the Article

Other writers have ably examined the decisions by the Federal Reserve Board on applications of bank holding companies (BHCs) to acquire finance companies and the legal guidelines governing those decisions.<sup>1</sup> This article examines the considerations which provide or are urged by the parties concerned as providing a rationale for the acquisition of a finance company from the viewpoint of a BHC or, more specifically, of its common stockholders.<sup>2</sup> For example, First National Boston initially indicated a willingness to pay almost twice as much for the shares of Liberty Loan as they were selling for on the market.<sup>3</sup> As a more direct illustration, the closing price of Dial Financial Corporation fell in one day to 15 ¼ from the previous day's closing price of 22 3/8 when the acquisition of Dial by Chase Manhattan Corporation was denied by the Federal Reserve Board. At issue in this paper is whether a well-managed company, such as Dial, is really worth that much more as part of a BHC than when operated independently. While shareholders of finance companies in some instances have been able to sell out at prices that at least approached their fondest dreams at the time, will the BHC shareholders (some of whom are now ex-shareholders of finance companies) also benefit from these acquisitions?

The soundness of the rationale for BHC acquisitions of finance companies is not entirely irrelevant to the Board's decisions concerning the public benefits emerging from these transactions. If the acquisitions prove to be less profitable than anticipated, some BHCs may be loath to reduce credit insurance premiums and finance charges and to open new finance offices, even though these actions were offered as public benefits to outweigh the possible anticompetitive effects of the mergers. Alternatively, management of BHCs may be tempted to try to offset the shortfall in anticipated profits from acquired finance companies by engaging in high-risk, speculative activities.<sup>4</sup> These outcomes do not appear to be in the public interest.

After a brief review of the growth of bank holding companies, the various reasons advanced for acquiring finance companies are analyzed. For the most part, these arguments are taken from applications filed by BHCs with the Federal Reserve Board. This study is followed by an analysis of other possible reasons for acquisitions that were not set forth in the applications.

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<sup>1</sup> Blaine, "Opportunities and Limitations for Expanding into Bank Holding Companies," 90 Banking L.J. 290-309 (1973). Chase, "The Emerging Financial Conglomerate: Liberalization of the Bank Holding Company Act," 60 Georgetown L.J. 1225-1251 (1972). Greenspan, "Bank Holding Companies: Competition, Capital and Nonbanking Acquisitions," 90 Banking L.J. 560-577 (1973). Hessee & Seelig, "An Analysis of the Public Benefits Test of the Bank Holding Company Act," 56 Monthly Rev. 151-162 (1974). Shay, "Bank Holding Company Acquisitions in the Consumer Finance Field," 3 Consumer Credit Leader 4-5ff (1973).

<sup>2</sup> In most instances the decisions of the Federal Reserve Board approving and disapproving applications seem to have been well founded. Quite likely, some of the small- and medium-sized finance companies acquired by BHCs could not have survived the squeeze between rising costs of capital and fixed rate ceilings on loans. Consequently, these decisions by the Board have enabled some firms to continue to compete in the face of outmoded rate ceilings that would otherwise have eliminated them and many consumers from the legal market for cash credit.

<sup>3</sup> Anreder, "Beautiful Balloon?" Barron's, April 29, 1974, p. 23.

<sup>4</sup> *Id.* at 3.

## **Growth of Bank Holding Companies**

Concern that mergers and the growth of holding companies would lead to excessive concentration in banking led to the passage of the Bank Holding Company Act of 1956 giving the Federal Reserve Board power to regulate BHCs. However, since this legislation applied only to companies controlling 25 percent or more of the voting stock of two or more banks or otherwise controlling the election of a majority of the directors of two or more banks, one-bank holding companies were excluded from the Act. The exemption for one-bank holding companies was continued by the 1966 amendments to the Act, but the ensuing rapid expansion of one-bank holding companies finally led Congress in 1970 to place them under the jurisdiction of the Federal Reserve Board by further amendments to the Bank Holding Company Act. Under these same amendments the Federal Reserve Board may permit a BHC to engage in nonbanking activities provided that (1) they are "so closely related to banking or managing or controlling banks as to be a proper incident thereto," and (2) the activity "can reasonably be expected to produce benefits to the public . . . that outweigh possible adverse effects. . . ." Under Section 225.4(a)(1) of Regulation Y the Board has determined that "making or acquiring . . . loans and other extensions of credit . . . such as would be made, for example, by a mortgage, finance, credit card, or factoring company" is so closely related to banking as to be a proper incident thereto.

The number and economic significance of BHCs has expanded dramatically. From fifty-three registered bank holding companies controlling 8.3 percent of U.S. commercial bank deposits at the end of 1965, the number has grown to 1,677 at the end of 1973 controlling 65.4 percent of deposits.<sup>5</sup> Most of this increase occurred after mid-1968. Interestingly enough, in spite of this growth of BHCs and the obvious dominance of the field by the giants, the nationwide aggregate concentration of domestic deposits held by the 100 largest banks fell to 47 percent from 49 percent between 1968 and 1973.<sup>6</sup> However, without the holding company acquisitions, nationwide concentration would have fallen 4.3 percentage points, rather than only 2.0 percentage points.<sup>7</sup>

The permission granted BHCs to acquire finance companies has had a notable impact on the structure of that industry. Over the period from 1971 through June 30, 1973, eighty-six applications to acquire finance companies were reviewed by the Federal Reserve Board; 93 percent of these were approved and the balance (six applications) denied.<sup>8</sup> The acquisition movement has been so pervasive that one BHC applicant noted that in early 1974 "of the 100 largest finance companies, only 11 consumer finance companies are either unaffiliated with a major corporation or have not announced a pending affiliation."<sup>9</sup> If the twenty-two commercial and factoring companies are excluded from the list of 100 largest finance companies, affiliates of major corporations held 87.5 percent of the assets of the remaining seventy-eight consumer finance companies.<sup>10</sup> At issue is whether these acquisitions of finance companies have benefited the common stockholders of BHCs.

### **Reasons Advanced for Acquisition of Finance Companies**

The undistinguished record of conglomerate mergers has been documented in several studies. Melicher and Rush concluded that "while the conglomerate firms achieved a level of performance comparable to the

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<sup>5</sup> 60 Fed. Reserve Bull. A83 (1974).

<sup>6</sup> The apparent reason for this decline was the fact that small banking organizations expanded more rapidly than their large competitors.

<sup>7</sup> Talley, "The Impact of Holding Company Acquisitions on Aggregate Concentration in Banking," Staff Economic Study No. 80. Washington, D.C., F.R.B. (1974).

<sup>8</sup> Hesse & Seelig, note I supra at 159.

<sup>9</sup> Application by First Chicago Corporation to acquire American Finance System Incorporated, Supplementary Memorandum 15 (Dec. 28, 1973).

<sup>10</sup> Id. at 16.

considered nonconglomerate firms, their performance was not at all outstanding." <sup>11</sup> Gort and Hogarty<sup>12</sup> found in their study that

- "(1) mergers, on the average, have an approximately neutral effect on the aggregate worth of firms that participate in them;
- (2) the owners of acquiring firms lose on the average; and
- (3) the owners of acquired firms gain on the average."

The record of BHC acquisitions of banks has been equally unimpressive.<sup>13</sup> For example, Piper and Weiss found that "On average the 102 bank acquisitions studied were breakeven investments that did not result in higher earnings per share for the holding companies in 1967 than would have been achieved in the absence of acquisitions."<sup>14</sup> One reason they advanced for the lackluster performance was the median premium of 16 percent paid for the acquisitions. Jessup adds the explanation that "Failure of past comparative studies to detect significant changes in operating performance is not surprising when most of the acquired banks are sufficiently large to approach firm and plant operating efficiency."<sup>15</sup> Since commercial banks have both paid high premiums and often acquired quite large finance companies, the reasons justifying these acquisitions must be persuasive if they are to improve upon the undistinguished performance that has characterized conglomerates and multi-bank holding companies.

### *Stabilization of Earnings*

An important feature of BHC applications to acquire finance companies is the assertion that earnings of finance companies and banks are negatively correlated over time. In periods of tight money, rising cost of funds pressing against fixed (and often obsolete) rate ceilings sharply reduces the net profits of finance companies, while banks' earnings benefit from increased yields on their loan and investment portfolios. An additional contribution to stabilization of earnings is claimed as a result of diversification across product lines and state boundaries. A typical summarization of this advantage is found in the Philadelphia National-Signet application:<sup>16</sup>

"Applicant wishes to acquire Signet for the following reasons and expects to obtain the following benefits thereby: . . .

"Approval of this acquisition would allow Applicant to enter the consumer lending business in new geographic areas outside the areas permitted to it as a bank....

"Applicant expects the consumer finance business to provide diversification to its earnings picture since consumer finance companies tend to outperform banks in periods of low interest rates."

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<sup>11</sup> Melicher & Rush, "The Performance of Conglomerate Firms: Recent Risk and Return Experience," 28 J. Finance 387 (1973).

<sup>12</sup> Gort & Hogarty, "New Evidence on Mergers," 8 J. Law & Econ. 175 (1970).

<sup>13</sup> Jessup, "Analyzing Acquisitions by Bank Holding Companies," 5 J. Bank Research 55-63 (1974). Lawrence, *The Performance of Bank Holding Companies*, Washington, D.C., F.R.B. (1971).

<sup>14</sup> Piper & Weiss, "The Profitability of Multi-bank Holding Company Acquisitions," 29 J. Finance 167 (1974).

<sup>15</sup> Jessup, note 13 *supra* at 62.

<sup>16</sup> Application by Philadelphia National Corporation to acquire Signet Corporation, April 19, 1973, pp. 21-22.

Will such diversification, in and of itself, raise the market value of the BHC? Levy and Sarnat<sup>17</sup> have shown that in perfect capital markets value *cannot* be created through merger of diversified firms. In essence, the individual stockholder could buy shares of the Philadelphia National Bank and shares of Signet and "self-diversify" to achieve the same benefits available through the corporate merger. While capital markets may not be perfect, the substantial premiums paid by BHCs to acquire finance companies imply a level of market imperfection that is difficult to accept. In addition, the individual investor can "self-diversify" more efficiently than can the BHC. As Smith and Schreiner<sup>18</sup> have pointed out, a BHC must ordinarily make a "lumpy" investment; that is, it must buy all of the finance company. In contrast, the individual investor may buy whatever proportions of a finance company and bank that he wishes and, in addition, may have a "piece" of Household and Beneficial, an option not as open to a BHC because of antitrust laws and, limitations of the Bank Holding Company Act.<sup>19</sup> In short, the mere fact that BHC earnings would be stabilized does not provide a valid rationale for acquisition of finance companies.

### *Financial Advantages*

A major argument advanced by BHCs in their applications to justify acquisition of finance companies is that the acquired firm's cost of capital will be lowered. With the cost of borrowed funds of consumer finance companies at about 27 percent of gross revenues, 20 any savings in these costs would have a significant impact upon the profitability of the acquisition. As will be seen below, the anticipated savings in financing also provides the rationale for a BHC's offering additional financial services and achieving more rapid growth, as well as for lowering finance charges and credit insurance premiums. Thus a great deal of the economic argument for acquisition of finance companies by BHCs rests on the validity of claimed financial advantages.

### *Factors Favoring Lowered Cost of Borrowings*

The two elements leading to a lowered cost of borrowings are well summarized in the Philadelphia National Signet application :<sup>21</sup>

"Signet, while it presently does receive the prime rate on its bank borrowings, cannot obtain competitive rates on its commercial paper and unsecured long-term borrowings from institutional investors and the public. Signet's affiliation with Applicant should lower these borrowing costs and enable Signet to generate funds internally for growth and for its lending activities.

"While Signet's extremely conservative debt to liquid net worth equity ratio, 4.8 to 1, makes it a very strong -financial entity, the strength that affiliation with the Applicant will bring it will enable it to maintain that strength and at the same time obtain additional funds . . . to increase its debt to equity ratio and thereby raise additional capital that it needs to grow."

The lowered cost of borrowing would stem from several sources. First, under the "financial umbrella" of the BHC, the finance company should be able to borrow at reduced rates on its own. Second, commercial paper

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<sup>17</sup> Levy & Sarnat, "Diversification, Portfolio Analysis and the Uneasy Case for Conglomerate Mergers," 26 J. Finance 795-802 (1970).

<sup>18</sup> Smith & Schreiner, "A Portfolio Analysis of Conglomerate Diversification," 24 J. Finance 425-444 (1969).

<sup>19</sup> A bank holding company may acquire, without Federal Reserve approval, not more than 5 percent of the outstanding voting shares of any company. Bank Holding Company Act § 4 (c) (6), 12 U.S.C. § 1843 (c) (6).

<sup>20</sup> The ratio studies of consumer finance companies prepared by the First National Bank of Chicago show interest expenses at 27.8 percent of gross revenues for the year ended December 31, 1973. Similar data from the "NCFR Research Report on Finance Companies in 1973" show cost of borrowed funds at 26 percent of gross revenue

<sup>21</sup> Note 16 supra at 23-24.

issued by the BHC would be substituted in whole or in part for bank borrowings when that would result in a cost savings. Third, in anticipation of that substitution, compensating balance requirements would be changed from a flat 15 percent requirement, whether borrowing or not, to 10 percent of the line when not borrowing and 20 percent when borrowing. This change would lead to lower cost bank lines to back up issues of commercial paper.

Cost of capital would then be further reduced by increasing the ratio of debt to net worth. For example, when Stephenson Finance was acquired by NCNB Corporation in 1969, "the unit had a 7.6-to-1 ratio of total liabilities to equity. At the end of last year [1973], the ratio approached 10-to-1."<sup>22</sup>

Can the reduced rates on borrowings and increased financial leverage be justified? After acquisition by a BHC the assets of the finance company are unchanged and remain in the same risk class. Diversification into untried fields, such as factoring and financial leasing, might move the finance company into a higher risk class. Why, then, should the cost of capital of a finance company be lower after acquisition by a BHC than when it was independently operating in the same line of business?

Some basis for a lowered cost of capital stems from the stabilization of earnings discussed in the preceding section. Levy and Sarnat<sup>23</sup> and, more fully, Lewellen<sup>24</sup> have shown that if there is a risk of bankruptcy for each of two firms, the probability of failure is usually reduced by their merger. Essentially, an investor holding stock in each firm cannot diversify away the risk of bankruptcy of either one, but in a merged company one division (or subsidiary) can rescue another.

It is difficult to believe, however, that a significant portion of the anticipated lowered cost of capital can be attributed to this financial rationale for mergers. Bankruptcies of finance companies (and to date, bank holding companies) have been very infrequent, in part because the line banks have generally done an effective job of policing the industry and in part because finance company receivables are very liquid. Certainly, the lender's risk is reduced by the merger, but it is not likely that it was much to begin with.

### *Economies of Scale*

Some reduction in cost of capital probably accrues to small finance companies acquired by large BHCs simply because of the economies of scale of raising funds. Small finance companies typically do not have access to the commercial paper market. Thus in its application to acquire the \$3.6 million City Finance Plan, First Pennsylvania Corporation could legitimately point to its ability to improve upon City's "limited capitalization,"<sup>25</sup> but it would be difficult to argue for significant economies of scale in financing in the proposed Chase-Dial merger.

### *Halo Effect*

A reduction in cost of capital may also stem from what might be termed a "halo effect," that is, from the dominating presence in the holding company of a large and respected commercial bank. Over time the market will probably recognize the fact that the nonbank subsidiaries cannot obtain material assistance from the associated bank in time of financial stress. If it exists, the halo effect is transitory.

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<sup>22</sup> Note 3 supra.

<sup>23</sup> Note 17 supra at 801.

<sup>24</sup> Lewellen, "A Pure Finance Rationale for the Conglomerate Merger, 26 J. Finance 521-535 (1971).

<sup>25</sup> Application by First Pennsylvania Corporation to acquire City Finance Plan. April 15, 1974, p. 34.

## *Policy of the Fed*

Under Section 3 (c) (2) of the Bank Holding Company Act, the Federal Reserve Board is charged with taking "into consideration the financial and managerial resources and future prospects of the company or companies and the banks concerned. . . ." In response to this requirement, the policy is abundantly clear from decisions of the Board and comments of the staff

"that bank holding companies and their nonbank subsidiaries be soundly financed so that they will, if anything, be in a position to add to the strength of their affiliated banks and in no way dilute or "trade on" that banking strength."<sup>26</sup>

Moreover, Brenton C. Leavitt, Director, Division of Banking Supervision and Regulation, FRB, has noted the expectation that nonbanking subsidiaries will maintain capital structures as balanced as those of firms operating independently.<sup>27</sup> Thus the posture of the Federal Reserve Board and its staff ensures that the reduced probability of bankruptcy from mergers does not include the potential rescue by a bank subsidiary of any associated nonbanking subsidiaries.

A minor exception to the general principle that a BHC bank subsidiary cannot rescue a finance subsidiary in time of stress is the potential that the bank might pay somewhat higher dividends into the BHC in an emergency. This is not a promising avenue of support. Periods of tight money that oppress finance companies' earnings are also times of expanding loan demands for banks. Thus the banking subsidiary cannot slow the growth of its equity base to sustain associated nonbank subsidiaries. At the same time, the cash flows available to service debt of many of the nonbank subsidiaries-finance companies, mortgage companies, REITs - are likely to be positively correlated, with the result that mutual rescue in a period of stress may be difficult.

Another possible source of reduced cost of capital is the sheer exercise of market power by the BHCs. No evidence reveals the use of such pressure at the present time. However, it would be worthwhile to inquire in further research whether finance subsidiaries of BHCs are accorded equal treatment with similar independent finance companies in such matters as compensating balances and availability of bank lines.

## *Synergism*

A synergistic merger has been defined as one in which "by the combination, more profits are generated than could be achieved by the individual firms operating separately."<sup>28</sup> More simply, it is the assertion that for some mergers,  $2 + 2 = 5$ . Synergy may arise from spreading skilled management over a wider range of operations, achieving economies of scale, or selling products and services that are complimentary. Each of these synergistic effects has been alleged in BHC applications to acquire a finance company.

Claims of more productive use of skilled management are illustrated by First Pennsylvania Corporation's application to acquire City Finance Plan. It was argued that one of the public benefits would be City's access to the "management expertise of FPC's Consumer Finance Group."<sup>29</sup> Philadelphia National Corporation asserted a synergistic advantage from the acquisition of Signet Corporation through allowing Signet the use of its

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<sup>26</sup> NCNB Corporation, 58 Fed. Reserve Bull. 846 (1972). See also Leavitt, "The Philosophy of Financial Regulation," speech at Conference on the Bank Holding Company, Southern Methodist University, Dallas, April 7, 1974, pp. 23-24, 90 Banking L.J. 632 (1973).

<sup>27</sup> Shay, note I supra at 30.

<sup>28</sup> Weston & Brigham, *Essentials of Managerial Finance* 572 (1974).

<sup>29</sup> Note 25 supra.

"computer, marketing, and financial services."<sup>30</sup> Lawrence found in his studies that the BHC or the lead bank frequently provides staff services, such as accounting, auditing, and personnel services.<sup>31</sup>

### *Synergism in Managerial Skills*

Claims for synergism in managerial skills are difficult to sustain, however, in the face of arguments elsewhere in the applications that banks and finance companies operate in very different markets. This reasoning is advanced to support the claim that the proposed merger is between two "noncompeting" enterprises and to explain why the BHC is ill equipped to enter the finance company's field de novo. For example, in its reapplication to acquire Dial, the Chase Manhattan Corporation recognized the need for experienced personnel to operate consumer finance companies :<sup>32</sup>

"[I]t is also unlikely that, without the affiliation of Dial, Applicant would enter the consumer installment credit field outside of its own present service area. Specifically: (1) the consumer installment finance business requires special expertise and local exposure not at Applicant's disposal; (2) Applicant does not possess the amount of skilled management needed to maintain a consumer installment loan organization having wide network of offices. . . ."

Similarly, in its application to acquire Ritter Financial Corporation, Manufacturers Hanover Corporation documented the differences in the character of the Trust Company's business and that of Ritter. According to the application, a significant portion of Trust Company's loan applicants were "of a type that never do business with Ritter";<sup>33</sup> its net write-offs were much lower in relation to outstandings; it operated in the city, whereas Ritter's offices were located in predominantly rural areas; and, finally, "Applicant lacks the unique marketing and lending techniques and specialized personnel required to operate a successful consumer finance company."<sup>34</sup> In short, any synergy from spreading managerial skills possessed by the BHC to an acquired finance company is largely belied by statements in the merger applications attesting to the unique character of finance companies.

For the most part, BHCs do not claim significant economies of scale through the acquisition of finance companies. As noted earlier, some economies may result from the sharing of computer services. In some instances an acquired finance company may have offices of sub optimal size, wherein economies might be achieved by an infusion of additional capital. But the claims are for modest economies at best, and this posture is consistent with cost studies of the consumer finance industry.<sup>35</sup>

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<sup>30</sup> Note 16 supra at 23.

<sup>31</sup> Lawrence, "Operating Policies of Bank Holding Companies-Part II: Nonbanking Subsidiaries," Washington, D.C., F.R.B. (1974).

<sup>32</sup> Application by The Chase Manhattan Corporation to acquire Dial Financial Corporation March 1, 1974, p. 76 (reapplication to supplement application of July 25, 1973).

<sup>33</sup> Application by Manufacturers Hanover Corporation to acquire Ritter Financial Corporation, Aug. 30, 1973, p. 142.

<sup>34</sup> *Id.* at 157. The extent to which customers of banks and consumer finance companies overlap is open to dispute, because adequate studies are not available to show the demographic characteristics of borrowers from these two types of institutions. However, the Federal Reserve Board has concluded that banks and finance companies do compete in the personal loan field. See order dated Aug. 3, 1973, Denying Acquisition of Public Loan Company by Bankers Trust Corporation, New York, New York, 38 Fed. Reg. 21822 (1973), 59 Fed. Reserve Bull. 694-695 (1973).

<sup>35</sup> Bell & Murphy, *Costs in Commercial Banking: A Quantitative Analysis of Bank Behavior and Its Relation to Bank Regulation*, Boston, Fed. Reserve Bank (1968). Benston, "The Costs of Extending Consumer Credit at Consumer Finance Companies and Commercial Banks," *Technical Studies*, Vol. 11, National Commission on Consumer Finance. Washington, D.C.: U.S. Gov't Printing Office, forthcoming.

## *Complimentary Financial Services*

A major synergistic reason advanced by BHCs for acquisition of finance companies is that the offices of the finance companies will offer complementary financial services, both to consumers and to business firms. Thus it is proposed that the offices and personnel that are now making consumer loans will also offer diversified services to include<sup>36</sup>

"factoring, financial leasing, inventory financing, accounts receivable loans, real estate mortgage loans (including second mortgages), home repair loans, vehicle financing, credit for equipment purchases, and personal and business financial counseling."

Another commonly mentioned service is executive loans (generally exceeding \$7,500). The Hanover-Ritter application adds "loans by mail, small business loans, loans to local governmental units, revolving credit, loans to professionals, military personnel and students. . . ." <sup>37</sup>

It is not alleged that BHC-owned finance companies will offer services that are new to the market; it is the packaging of complementary financial services that is the proposed innovation. In denying, the Chase-Dial application, the Board was evidently unimpressed with the long list of financial services that would be offered as a result of the acquisition: "The record does not show to what extent such services are presently competitively unavailable in the markets served by Dial. . . ." <sup>38</sup> In fact, some of the financial services proposed by BHCs-such as automobile financing -were largely abandoned by finance companies some years ago because of their unprofitability. Over the period from 1955 to 1973, finance companies' share of the automobile market fell to 23 percent from 53 percent. Yet, the Chase Dial proposal argued that "CMC expects to develop this product [automobile finance] in Dial and to develop dealer and consumer financing plans for automobile and other vehicle production." <sup>39</sup>

What would permit a BHC-owned finance company to offer additional financial services, some of which were unprofitable when the finance company was independent? In large part the argument appears to rest upon an assumed lower cost of capital: " <sup>40</sup>

"Lower money costs should enable Signet ... to offer additional lending services in competition with other finance companies. Favorable consideration will be given by Signet to reentering the financing of purchases of used automobiles, expanding its financing of consumer durables, and commencing certain other types of financing."

Aside from the doubts cast on a significant lowering of money costs in the preceding section, this is not an entirely convincing argument. Surely, firms such as Household Finance and Beneficial Finance have a sufficiently low cost of capital and financial resources to establish "one-stop" financial centers. Perhaps an unspoken criticism in BHC applications is that finance companies have not been sufficiently innovative, that the key to offering complementary financial services is a willingness to innovate rather than a lowered cost of capital. While this is a possibility, there are at least three barriers to the development of such financial centers

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<sup>36</sup> Martinuzzi, The Chase Manhattan Corporation, Letter to Board of Governors of the Federal Reserve System, Oct. 4, 1973, p. 9.

<sup>37</sup> Note 33 supra at 173.

<sup>38</sup> Order dated January 30, 1974, Denying Acquisition of Dial Financial Corporation by The Chase Manhattan Corporation, New York, New York, 60 Fed. Reserve Bull. 144 (1974).

<sup>39</sup> Butcher, The Chase Manhattan Corporation, Letter to Board of Governors of the Federal Reserve System, Dec. 14, 1973, p. 7.

<sup>40</sup> Note 16 supra at 24.

that cast doubt on their viability as a means of achieving synergism: economies of scale, consumers' attitudes, and legal issues.

### *Hindrances to Establishment of Multi-service Offices*

If diversified financial services are to be offered economically, either the personnel must be multifaceted, or the office must be large enough to permit specialization. It has proved difficult to find personnel who can intelligently sell a wide range of financial services to a variety of consumers and business firms. To permit specialization of labor, therefore, an office must be fairly large and must draw business from a geographical area wider than that typically served by a personal loan office. Thus a BHC buying nine finance company offices in a city might find only one convertible to a financial services center, even though it pays a substantial premium for all of the offices.

Nor is there convincing evidence that consumers want to have all of their "financial eggs in one basket." One might, for example, expect consumers to employ only one bank credit card as a matter of convenience and to limit the billing to one a month. Yet about one-fourth of those with bank credit cards hold two or more cards.<sup>41</sup> Consumers are notoriously sensitive, if not secretive, concerning their financial affairs, and it may be some time before they willingly adopt the concept of a synergistic center for financial services. Finance companies have, in fact, experimented with financial service centers; yet none have crowed about their success.

From a legal point of view, there are additional hindrances to establishing multi-service offices. Several states have laws prohibiting finance companies from engaging in a "dual business," that is, both making cash loans and buying installment sales paper on the same premises. Other states have "brick wall amendments" prohibiting the making of loans and selling of other goods and services on the same premises. Equally uneconomic and anti-consumer forms of legislation are state laws "proscribing, within their territorial boundaries, the operations of nonbank financial units owned by out-of-state bank holding companies."<sup>42</sup> BHC acquisition of finance companies will lead to public benefits if they seek to strike down such anticompetitive legislation.

Another legal factor that affects the potential synergy of offering complementary financial services is the prohibition of tying agreements. Section 106 of the 1970 amendments and Regulation Y prohibit a bank (with certain exceptions for traditional banking practices), or its affiliates in the holding company, from providing credit or other services on the condition that the customer also take another service. Regulatory authorities are concerned not only with such coercive tying agreements, but also with the indirect effect of unexercised market power:<sup>43</sup>

"No coercion is 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 credit from the bank or 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."

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<sup>41</sup> Mandell, *Credit Card Use in the United States*, 33 (1972).

<sup>42</sup> Christopher, *Competition in Financial Services*, 29 (1974).

<sup>43</sup> Baker, "The Antitrust Merger Rules as Applied to Bank Acquisitions of Other Financial Enterprises," address before Briefing Conference on New Developments in the Regulation of Banking, Washington, D.C., March 25, 1971, pp. 12-13.

## *Problems of Tying Arrangements*

BHCs appear to be alert to the problems of coercive tying agreements and in their applications to acquire finance companies have noted the procedures by which they hope to prevent such arrangements. For example, the Chase-Dial application sets forth both firm's procedures and includes a lengthy and explicit policy guide concerning tying agreements and reciprocity practices. This approach seems greatly superior to suggested legislation that would prohibit bank holding companies from offering nonbanking services either to customers using the lending services of the bank holding companies or within the market area where lending services are offered.<sup>44</sup>

It should be evident, however, that existing and potential restrictions on tying arrangements substantially reduce the potential synergistic effect of cross-selling financial services. If, in fact, affiliates of BHC "offer products on a separately-priced basis" and "avoid all coercion-expressed or implied, which may affect the customer,"<sup>45</sup> a BHC gains a measurable economic advantage by establishing a "department store" of financial services only if consumers *prefer* that arrangement. As suggested earlier, the evidence is lacking to support this contention.

The foregoing discussion has uncovered very little in the way of potential economic benefits stemming from any "synergy" arising in the acquisition of a finance company by a BHC—from spreading the benefits of skilled management, achieving scale economies, or selling complementary services. In view of earlier studies of mergers, the difficulty of achieving synergy should come as no surprise.<sup>46</sup>

## *Potential Growth*

Applications of BHCs to acquire finance companies also point to the potential growth that would be fostered. While the growth has procompetitive implications, the analysis here questions growth as a means of achieving an adequate return on investment for the P--.IC shareholders. Proposed growth in number of offices is often substantial: Dial to increase its 450 offices by 150; Ritter to add 85 offices to its present 125; and AFS to open 75 offices to a net of about 700 (after disposing of Illinois offices)—in all cases the projections being over a three-year period.

Growth per se has no special value to BHC stockholders, since they can seek growth on their own by buying shares of "growth" firms. That being the case, there is no reason for a BHC to pay a premium to buy shares of a growth company, any more than it should pay a premium to diversify its investments geographically or to obtain streams of earnings negatively correlated with those of its bank subsidiaries. Only if a BHC can offer a finance company a unique opportunity to attain growth can it justify paying a premium for the finance company's shares with prospective "growth" as the rationale. Even in this case, the BHC shareholders must ask whether most of the value from the added growth has been transferred to the stockholders of the finance company via the premiums paid to acquire their stock.

The rationale for an accelerated rate of growth facilitated by the BHC appears to rest largely on lowered cost and greater availability of funds, an assumption discussed in a previous section. For example in the Chase Manhattan Corporation's (CMC) reapplication to acquire Dial it is stated:<sup>47</sup>

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<sup>44</sup> Staff Report on Financial Institutional Reform to House Committee on Banking and Currency, 201 (Aug. 15, 1973).

<sup>45</sup> Baker, "Bank Holding Company Act—The De Novo Doctrine, the Anti-Tie-In Provisions, and Other Antitrust Implications," 29 Bus. Lawyer 245 (1973).

<sup>46</sup> Note 12 supra at 167-184. Kitching, "Why Do Mergers Miscarry?" 45 Harv. Bus. Rev. 84-101 (1967).

<sup>47</sup> Note 36 supra at 7.

"If the application is not approved, it is not anticipated that Dial would be in a position to proceed as aggressively to establish *de novo* offices because Dial is limited in the extent to which it can sacrifice shorter term earnings in order to enhance long run earnings potential. Also, *de novo expansion* involves risk elements which Dial has been willing to assume only to a limited degree."

It seems reasonable to ask why a sacrifice of short-term earnings and an assumption of increased risk is more palatable to CMC stockholders than to Dial stockholders. Although not explicitly stated, the answer must lie in the ability of CMC shareholders to diversify away some of the risk of bankruptcy through holdings of other nonbank subsidiaries, an option not immediately open to the stockholders of Dial. As noted earlier, it is hard to believe that the premerger and post merger differences in risk of bankruptcy are great enough to justify both a significantly greater growth rate and a substantial premium for the acquisition.

Although the barriers to growth may be lowered to some degree by a reduced cost of capital and greater availability of funds, other very potent legal barriers remain. These are, in fact, the very obstacles cited by BHCs in explaining their inability to establish offices *de novo*. Principal among these are strict licensing requirements (convenience and advantage (C&A) laws), low rate ceilings, and restrictions on size of loans.

In explaining why it would be difficult for it to enter the consumer finance business *de novo*, the Manufacturers Hanover Corporation provides a careful explanation of the chilling effect of C&A statutes: "

"Twenty-six additional states have C&A statutes which would hinder a *de novo* effort.... Because of such impediments, the procedure for *de novo* entry can be tortuous and time-consuming. Such state regulations make it impractical, if not impossible, for Applicant to enter the consumer finance business *de novo* to any meaningful degree in any of the six states in which Ritter operates."<sup>48</sup>

Presumably, C&A would significantly hinder *de novo* entry in the states in which Ritter does not operate. Yet at a later point in the discussion of "overriding public benefits," Hanover pledges that it "is committed to expand Ritter's operations in West Virginia" and anticipates expansion into Delaware, Florida, Kentucky, Maryland, and Massachusetts.<sup>49</sup> Yet all of these states have C&A statutes. Delaware and Massachusetts are noted for their tight administration of their C&A statutes and Florida for "medium" enforcement.<sup>50</sup> Another memorandum explaining the difficulty of *de novo* entry reported that over the four-year period, from 1968 to 1972, the number of licenses in Florida *declined* by 100.<sup>51</sup> In his supporting statement to the Hanover-Ritter application Shay observes that Delaware and Massachusetts are states in which finance company personal loan outstanding are highly concentrated, and that expansion of Ritter into these states would be beneficial to the public.<sup>52</sup> The analysis is sound, but there is no reason to believe that a BHC-owned finance company will be any more successful in surmounting the legal barriers to competition in those states than an independent finance company.

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<sup>48</sup> Note 33 *supra* at 161.

<sup>49</sup> *Id.* at 175.

<sup>50</sup> Chapman & Shay, *The Consumer Finance Industry: Its Costs and Regulation*, 113 (1967).

<sup>51</sup> Holroyd, Memorandum commenting on the proposed acquisition of American Finance System Incorporated by First Chicago Corporation, March 8, 1974, p. 9.

<sup>52</sup> Shay, "Statement in Support of the Application by Manufacturers Hanover Corporation to Acquire Ritter Financial Corporation," 11-12 (April 9, 1974).

Other legal barriers inhibit entry to these states by Ritter, even when acquired by Hanover. In addition to tight enforcement of C&A statutes, Delaware limits rates to about 23 percent. West Virginia caps small loans at \$800, and rate ceilings on industrial loans above that amount range from about 15 percent to 18 percent. Kentucky limits small loans to \$1,200, and rate ceilings on larger industrial loans vary from about 12 percent to 18 percent. Coupled with C&A requirements, these and similar state statutes significantly restrict de novo entry of BHC-owned finance companies, just as they curb direct de novo entry of BHCs. Quite possibly one of the most beneficial results of the widespread acquisition of finance companies by BHCs will be to enlist the support of BHCS in striking down these segmented market barriers, either directly or through their replacement by the Uniform Consumer Credit Code. In the meantime, the potential growth and accompanying profits of BHC-owned finance companies will be delayed.

### *Offsetting Costs*

The preceding analysis has indicated that there may be some gains to the stockholders of BHCs through acquisitions of finance companies. The principal benefits appear to stem from lowered cost of capital for the acquired companies, especially if they are relatively small. The market value of diversification, synergism, and potential growth appears negligible, if not illusory. Offsetting these gains in whole or in part are the very substantial premiums above market price that have been paid to acquire finance companies. Of lesser importance are other added costs that will be summarized briefly in this section.

First, to acquire a sizable finance company, a BHQ must prepare a lengthy and costly application to the Federal Reserve Board. These outlays precede by some months the actual acquisition if permitted. In contrast, were a nonfinancial firm to make the same acquisition, the sale could be completed in a matter of days.

Second, under the Bank Holding Company Act (Section 5 (c)), the Board may make examinations of each subsidiary of the BHC and assess the cost against the BHC. This would be in addition to the examination and costs charged by a state regulatory agency. In a general sense, whereas the regulations imposed by a state have been for the protection of consumer-borrowers of finance companies, the regulations effected by the Board are for the protection of consumer-depositors. The dual regulation is not unwarranted, but it does add to the costs of the BHC-owned finance company.

Third, a BHC typically promises that it will reduce both credit insurance premiums and finance charges. With respect to premiums for credit insurance the Board has stated:<sup>53</sup>

"To assure that engaging in the underwriting of credit life and credit accident and health insurance can reasonably be expected to be in the public interest, the Board will only approve applications in which an applicant demonstrates that approval will benefit the consumer or result in other public benefits. Normally such a showing would be made by a projected reduction in rates or increase in policy benefits due to bank holding company performance of this service."

Commitments to reduce finance charges are also common. The Hanover-Ritter application promised "to cause the interest rates presently charged by Ritter's consumer finance offices to be reduced by 4% on all new loans (including renewal loans). . . ." <sup>54</sup> In its application to acquire American Finance System Incorporated, First Chicago Corporation pledged "that the maximum charge on any one loan will not exceed 2½ % per month.

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<sup>53</sup> 12 C.F.R. 225.4 (a) (10).

<sup>54</sup> Note 33 supra at 17 1.

This will result in a reduction in the maximum rate allowed in 27 states."<sup>55</sup> The Chase-Dial application promised reductions in finance charges and insurance charges totaling \$1.3 million, about 1.6 percent of Dial's total gross revenues for 1973.

The commitments to reduce gross income (whether from insurance premiums or finance charges) are puzzling, because the apparently accepted doctrine is that rate reductions constitute a public benefit. In point of fact, the requirement that "public benefits" be shown puts the Board in an awkward position. A reduction in a finance company's income that is compelled and not in response to market forces will help some segments of the public, but harm others. Whereas rate reductions benefit those consumers who can obtain loans from finance companies, high-risk borrowers seeking small loans are likely to be eliminated from the legal loan market. Alternatively, if the promised rate reduction is based upon an assumed lowered cost of capital, additional consumers who might otherwise have been permitted to enter the legal loan market had the rates not been reduced are denied access.<sup>56</sup> It can hardly be said that these marginal borrowers will receive a public benefit from the rate reduction. But how is the Board to balance these gains and losses to different groups of consumers?

In its *Report* the National Commission on Consumer Finance observed that "average rate ceilings lower than about 28 percent appear to restrict credit availability directly and substantially, regardless of whatever influence other variables may have."<sup>57</sup> If rates are capped at 30 percent, as promised in the First Chicago-AFS application, the average yield will obviously be below 28 percent, and one must question whether the public benefits test is met. More-over, if the self-imposed rate structures are sub-optimal from a finance company's standpoint, the value of the acquisition to the BHC is diminished accordingly.

### **Other Reasons for Acquisitions**

There are other possible reasons for acquisition of finance companies by BHCs that go unstated in the applications. It may be that the BHC has simply found an undervalued investment in an imperfect market, that the management of the BHC is human and wishes to manage a larger firm, or that BHCs are positioning themselves to become nationwide banks, much along the lines of the Canadian system. Each of these possibilities bears analysis, although the last is by far the most provocative.

#### *Undervalued Investment*

The many studies that attest to the efficiency of the money and capital markets make it hard to believe that BHCs have really discovered firms, let alone an entire industry, that were significantly undervalued in the market. Occasionally, companies may have been undelivered, so that by introducing greater leverage the BHC could raise the value of its acquisition. Alternatively, some finance companies may have been poorly managed,

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<sup>55</sup> Note 9 *supra* at 48. This is less of a concession than might appear. While the maximum rate on small loans is 3 percent per month under many statutes, that rate applies only to the first \$150 to \$300 of the initial unpaid balance, depending upon state law. For example, in West Virginia, where AFS operates, the 3 percent rate applies only to the first \$200 of unpaid balance on interest-bearing loans. But only 2.2 percent of the loans made were in this bracket during the fiscal year ending June 30, 1973. The maximum rate on such loans falls below 30 percent (2V2 percent per month) on twelvemonth loans above \$600). About 74 percent of the loans made by finance companies in West Virginia in the fiscal year ending June 30, 1973 were in this category. State of West Virginia, Seventy-Third Report of Financial Institutions at 115 (Fiscal Year Ending June 30, 1973).

<sup>56</sup> Note 52 *supra* at 21-24 also points out that under certain market conditions public benefits may be realized from maintenance of rates charged, while accepting riskier applicants, or by de novo -expansion. The ways in which the public may benefit will vary depending upon the extent of competition in each of the various markets, which may range in scope from a few city blocks to several square miles.

<sup>57</sup> *Report of the National Commission on Consumer Finance*. Washington, D.C., U.S. Gov't Printing Office, 133 (1973).

and the BHC might increase the market value of its acquisition by replacing the management—a point that might understandably be omitted from the application to acquire the firm. Even though their investments in finance companies are "lumpy" and potentially less efficient than diversified investments of individual shareholders or mutual funds, the top management of a BHC has for more control over the management of its subsidiaries than do individual shareholders or mutual funds. The value of this control is suggested by a recent study showing that conglomerates are more profitable than mutual funds.<sup>58</sup> Since there are many obviously bright people in charge of the varied finance subsidiaries of BHCs, it may be that by dint of tough-minded exercise of above-average managerial skills they will ultimately justify the high premiums paid. However, the record of bank acquisitions by BHCs has not supported this outcome.<sup>59</sup>

### *Desires for "Bigness"*

Piper and Weiss suggest that one of the motives of multi-bank holding company acquisitions has been "to gain the added prestige of a larger banking group."<sup>60</sup> Accompanying growth in asset size and volume of financing may be increased salaries, although careful study of other industries demonstrates that reported profits and the market value of a firm's stock are more important to the level of executive compensation than sales.<sup>61</sup> The desire for "bigness" is an understandable human motive but one that may not be shared by, or of benefit to, the BHC stockholders.

### *Nationwide Banking*

Finally, it seems likely that BHC management ultimately has in mind the creation of a nationwide banking system that will be significantly facilitated by the development of an electronic funds transfer system (EFTS). Whereas "loan production offices" may presently be established across state lines, approval and acceptance of an application must occur at an office of the bank. With leased wire arrangements and EFTS, the formalities of this approval and dispersal of funds could take place with great rapidity from offices scattered throughout the country. At the same time the offices of BHC-owned finance companies could be used to tap savings, to sell CDs or variable interstate notes, and to move funds to the money centers via EFTS. With debit cards (and credit cards) issued through the finance company offices, consumers in small towns could readily transfer funds to and from their accounts at money center banks.

Alternatively, BHCs may envision converting finance company offices into "consumer banking" offices. As observed in an earlier issue of this journal, if authorized by the Board, a holding company could offer only demand and time deposits and consumer loans at such offices without their being designated as banks.<sup>62</sup>

The eagerness with which BHCs have sought finance companies suggests strong motivation. Even though the development of a nationwide banking system may be some years away, it is understandable that BHCs would seek to position themselves in the market via acquisition of finance companies.

If the acquisition of finance companies by BHCs is, then, a means to an ultimate end of nationwide banking, rather than merely an investment to diversify financial services, the premiums paid to acquire finance companies may appear somewhat more reasonable. But if nationwide banking is the real motive, more attention needs to be

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<sup>58</sup> Weston, Smith & Shrieves, "Conglomerate Performance Using the Capital Asset Pricing Model," 54 Rev. Econ. & Stat. 357-363 (1972).

<sup>59</sup> Note 14 supra at 163-174.

<sup>60</sup> Id. at 174.

<sup>61</sup> Lewellen & Huntsman, "Managerial Pay and Corporate Performance" 60 Am. Econ. Rev. 710-720 (1970).

<sup>62</sup> Note 3 supra.

directed to its economic implications. As former FRB Vice-Chairman Robertson commented: "It [interstate banking] could be good for the country, but it should be done with our eyes open. We shouldn't just creep into it." <sup>63</sup>

## Conclusion

Nothing in this analysis should be construed as questioning the propriety of permitting BHCs to expand by acquiring finance companies or the decisions of the Federal Reserve Board in allowing or denying applications. Instead, the purpose of this article has been to examine the validity of reasons advanced by BHCs for their acquisition of finance companies from the point of view of the BHC stockholders. A review of the applications has revealed some interesting anomalies.

First, it may be true that such acquisitions enable BHCs to expand beyond their state's boundaries, to diversify among different financial services, and to achieve greater growth. However, since the individual stockholder of BHC can make these same moves on his own, there is no reason for the BHC to do it for him. Indeed, the substantial premiums paid by BHCs to acquire finance companies suggest that BHC shareholders would be better off with self-diversification.

Second, BHCs do benefit their shareholders by diversification to the extent that the probability of bankruptcy of the conglomerate firm is lower than the probabilities for the divisions, were they independent entities. The value of this reduced risk is significantly mitigated by the fact that the largest component of the BHC, the commercial bank subsidiaries, cannot rescue the nonbank subsidiaries in times of stress. Nonetheless, the net result is some reduction in the cost of capital, particularly when the finance company acquired is relatively small.

Third, a number of applications seem to be internally inconsistent along at least two dimensions. On the one hand, it is argued that lack of expertise prohibits BHC de novo, expansion into consumer finance. On the other hand, synergistic benefits from spreading the managerial skills of BHC management are also claimed. On the one hand, it is quite accurately pointed out that C&A licensing requirements and low ceilings on size of loan and finance charges severely limit BHC de novo expansion. Yet, on the other hand, rapid de novo expansion is promised once the acquisition is approved.

From the viewpoint of BHC stockholders the economic rationale set forth in BHC applications to acquire finance companies is highly questionable, particularly in the light of the premiums paid to effect the acquisitions. In this narrow context some of the acquisitions appear to have been unwise-more a product of "followership" than of sound analysis. But it is also possible, and perhaps likely, that the basic reason for the wave of acquisitions is the desire of major BHCs to position themselves for a nationwide banking system based upon an electronic funds transfer system. If this wider context is accepted, it is too early to judge the wisdom of BHC management. Only time will tell whether they are unduly optimistic about the rapidity with which EFTS develops and the willingness of Congress to accept interstate banking.

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<sup>63</sup> Baker, "Bank Expansion: Geographic Barriers," 91 Banking LT 723 (1974).