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STATEMENT

by

PHILIP E. COLDWELL

MEMBER

of the

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

before the

Subcommittee on Financial Institutions
Supervision, Regulation and Insurance

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

on

H.R. 9086

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Mr. Chairman, I appreciate the opportunity to testify before this Subcommittee on behalf of the Board of Governors on H.R. 9086, the Safe Banking Act of 1977. Before I address some of the more important provisions of the bill directly, the Board believes that it is important to place the bill in the context of prior efforts.

As you are aware, Mr. Chairman, in September 1975 the Board proposed legislation on behalf of the three bank regulatory agencies designed to improve supervisory effectiveness. These proposals arose from a study by the agencies subsequent to the Franklin National Bank failure of possible legislative actions to aid the agencies in their goal of preventing or ameliorating difficult bank situations.

The legislation recommended by the agencies was included in the Financial Reform Act and was in large part embodied in S. 2304 which was reported out of the Senate Committee on Banking, Housing and Urban Affairs in the 94th Congress. This legislation was subsequently found to be necessary and supported by the General Accounting Office in its study entitled Federal Supervision of State and National Banks. In this session of Congress, the majority of these proposals were reported out of the Senate Banking Committee as S. 71 and, in fact, recently passed the full Senate.

The Board believes that the proposals embodied in S. 71 are relatively noncontroversial and are needed in our on-going supervisory work. As you are aware, H.R. 9086 contains a large number of provisions which are unrelated to the basic supervisory thrust of S. 71 or raise new issues. Furthermore, many of these provisions are likely to be controversial and we are frankly concerned that such controversy will interfere with the passage of the other necessary, noncontroversial provisions.

Many of the additional titles which go beyond the basic supervisory thrust of S. 71 represent a potential over-reaction to recent public discussion of certain practices. The Board does not condone abuse of a bank for the benefit of insiders. In fact, the majority of the proposals reflected in the Board's original legislative recommendations in the supervisory field are designed to curb such abuses and enable the agencies to take more effective supervisory action when such abuses are discovered. However, we believe that the adoption of additional restrictions without the benefit of a full factual analysis could result in significant harm to the business of banking and interfere with the provision of credit to the economy. If the practices sought to be corrected are indeed potentially harmful and widespread, then legislative action may be needed. However, if such practices appear to be sometimes beneficial or reflected in only a few banks, then examination, supervisory, and perhaps regulatory, action reinforced by the additional tools of S. 71 would appear to be adequate to meet the problem.

The combination of the existing provisions of S. 71 with the additional restrictions in H.R. 9086 are excessive in light of existing knowledge of the problem and too severely restrict the ability of banks to provide loans to credit-worthy local businesses. Furthermore, the legislation will severely interfere with the ability of financial institutions to obtain qualified outside directors. The provisions relating to transfers of bank stock by individuals are too restrictive in view of the known nature of the problem and would interfere with the ability of banks to obtain capable successor management through which it will serve the community. Again, substantial revisions are proposed in the Bank Holding Company area without a demonstration that there is a problem needing to be remedied. These portions of the bill should not be enacted without extensive analysis and study of the problems involved.

For these reasons, we urge that the Subcommittee go forward with those noncontroversial provisions of H.R. 9086 which are embodied in S. 71 and for which the agencies have an on-going need, and separate out other portions of the bill for further study and consideration. Board testimony on S. 71 reflects many of the prime reasons for this supervisory thrust and I ask that it be placed in the record on these hearings.

I would now like to turn to the Board's comments on some of the specific provisions of the bill. The bill is, as I have already noted, so extensive and touches on so many important areas that, in the time allowed, I will only be able to provide the Board's comments on some of the major issues raised by the bill. I am submitting for the record a section-by-section analysis of the bill which sets forth the Board's comments on those provisions of concern to the Board.

I will now turn to Title I of the bill, which incorporates many of the proposed improvements in the bank supervisory and regulatory area which passed the Senate in S. 71. As I have noted earlier, the Board strongly supports these provisions and urges their immediate enactment. However, the Board questions the need for some of the changes which have been made. In the area of "insider lending" particularly, the changes to S. 71 which are made in Title I are too restrictive and would unduly constrain legitimate lending practices without measurable countervailing public benefit. The net result of these provisions would be to prevent many businessmen from lending their expertise to bank boards.

First, Title I would modify the aggregate lending provisions of S. 71 so that they would apply to a director and his related companies whether or not that director was an officer or 10 per cent shareholder. The Board believes that such a provision would severely limit the availability of qualified directors for banks, particularly in smaller communities. In such smaller communities, it is not at all unusual for an outside director to control more than one local business. This bill would force the outside director to choose between the local availability of credit for those businesses and his service as a bank director. The result of such a choice could be to deprive the bank of experience and advice.

In our view, the requirement elsewhere in Title I that loans to insiders be approved by two-thirds of the board of directors and that such loans not be extended unless they are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons and do not involve more than the normal risk of repayment or present other unfavorable features adequately protects against possible abuses. Unless a director were also an officer or a 10 per cent or greater shareholder it is unlikely that he would be able to induce the other directors to make a questionable loan, particularly in view of the liability to which the other directors would subject themselves under the civil penalty provisions.

The requirement that the aggregate loan limitation on loans to covered insiders be set at 50 per cent of the statutory loan limit to an individual borrower will again provide a strong disincentive for outside directors to serve on bank boards. Once the statute has been amended to aggregate all loans for a particular insider and his related interests, it does not appear that there is any substantial decrease in risk to the bank's safety or solvency by moving from 10 per cent to 5 per cent of the total capital and surplus of the bank.

Title I further places a ceiling on aggregate lending to all insiders. We do not believe such a provision to be necessary or appropriate. The aggregation of loans to the interests of any one insider is based on the premise that such a concentration is more risky in the case of an insider because those loans might be made on less than an arm's-length basis. While an argument might be made that similar considerations of risk would support an additional limitation on the aggregate of a bank's loans to all insiders and their interests, our experience has not shown that an additional limitation is necessary. In cases that have come to our attention involving insider lending abuses, those abuses have been limited to one or a few, generally controlling, individuals and have not typically involved the entire board, particularly its outside directors. An additional limitation on the aggregate of loans to insiders and their interests, which would rule out the major portion of such loans, would be a serious deterrent to the ability of banks to attract independent outside directors. In addition, it would restrict a bank's ability to lend to companies and individuals best known by the bank to be credit-worthy and would require banks to ration credit among the directors and companies they control.

In closing the Board's comments on Title I of the bill, we believe that it is necessary to consider the cumulative effect of the proposals which have been made. In sum, if the proposals are adopted as proposed, a bank may find it impossible to obtain qualified outside directors who are required by a subsequent title of this bill. Such, almost punative, provisions should not be imposed since there is no showing of any significant number of instances where outside directors have abused their positions. Again, with respect to other insiders, the harshness of the remedy far exceeds the frequency of demonstrated abuses.

The next major portion of the bill on which the Board wishes to comment is Title VI, which would radically change the ground rules for the transfer of ownership of bank stock by requiring prior approval of the Federal Deposit Insurance Corporation (with input from the Comptroller of the Currency or the Board, as the case may be) before any individual could acquire control of an insured bank. Since 1956, in its consideration of the Bank Holding Company Act and the various amendments thereto, Congress has carefully drawn a distinction between corporate and individual ownership. In fact, it was not until 1970 that Congress expanded the coverage of the Bank Holding Company Act to partnerships owning bank stocks. Similar distinctions have been consistently drawn under the Savings and Loan Holding Company Act. These previous actions on the part of Congress have basically reflected a concern for the marketability of bank stocks, a desire not to unduly discourage changes in the control of banks, and a respect for the individual's rights to buy or sell stock. Particularly in the nation's smaller communities, successor ownership and management have to be readily available, and many changes in control and management of banks result in more effective and responsible ownership, are highly desirable, and should be encouraged.

Any regulatory requirement for prior approval would necessarily impose burdens, costs and delays which would hinder such changes, desirable as well as undesirable, restrict the marketability of bank stock, and discourage some young persons of promise from entering the banking industry. The costs and burdens of this type of Federal legislation should not be imposed on the more than 14,400 insured banks in the country without better demonstration of a compelling need for the legislation or that the goals of bank safety and soundness cannot be reached through less obtrusive legislation. Undoubtedly there are instances in which changes of control have led or will lead to adverse impacts on the bank involved. However, the Board seriously questions whether the approval process contemplated would prevent enough of these instances to justify the costs involved. Additionally, we are concerned whether appropriate standards for the exercise of discretion to permit or deny individual ownership can be drafted which will adequately balance the individual's rights with the protection of the institution. We believe the standards imposed in the Title as drafted are too indefinite and would give too much authority to the supervisory authority. Further, a conflict could arise between the standards applied for individual ownership under this Title and those imposed for corporate ownership under the Bank Holding Company Act.

In this regard, the Board believes that there is a less disruptive method by which the goal of attempting to prevent adverse impacts of bank ownership changes can be achieved. Section 7(j) of the Federal Deposit Insurance Act presently requires that reports of change of control of financial institutions be filed by the institution when it realizes that such a change has occurred. The Board believes that it might be appropriate to require filing of a report by the acquiring person no later than the date of consummation of any change of 25 per cent or more ownership. Civil penalties should apply for the failure to file such a report, and the report should contain much of the information required by Title VI. In this manner, if there were any circumstances regarding such a substantial ownership change which gave rise to a suspicion by the bank regulatory agency that the bank involved might be abused as a result of such change, the bank regulatory agency would be in a position to have its personnel monitor developments at the bank and take action before the bank suffered any serious adverse impact. We believe that such an approach would adequately balance supervisory concerns with individual rights and the necessity for the marketability of bank stock.

The Board believes that under certain circumstances there is some merit to the concept introduced in the bill of applying a margin requirement to all bank stocks whether or not publicly traded. However, we believe a requirement of a 50 per cent margin as proposed by the bill would make it extremely difficult to provide for successor ownership and management at smaller institutions in smaller communities. Rather, we believe a more appropriate margin would be 25 per cent and that there should be regulatory exemptive authority depending on the circumstances. Such a margin requirement should apply when control is being acquired and where the loan involved is from a commercial bank. Otherwise, such bank stock loans should be set on the same terms and conditions as other bank loans.

With respect to the provisions relating to correspondent balances, the basic purpose of Title VIII of the bill appears to be to prevent an insider of one bank from influencing the placement of such balances as a means of obtaining loans, probably at preferential terms, from another bank. To this end the title would prohibit bank A, which has a correspondent account from bank B, from lending to insiders of bank B, or if bank A has lent to insiders at bank B, from opening up a correspondent account for bank B.

The title goes on to prohibit a bank keeping a correspondent balance with another bank from making a loan to an insider of that correspondent or a bank having such a loan from opening up a correspondent account at such bank. With respect to the latter prohibition, there appear to be few, if any, known cases where banks providing correspondent accounts were abused in the manner which the provision is apparently designed to prevent and we question its necessity.

The Board strongly supports the purpose of preventing insiders from profiting through the placement of correspondent balances and we have previously taken action to attempt to insure that such abuses do not occur. The exposure to such abuse is particularly high in the case of an officer or controlling stockholder of a bank. However, rather than prohibit such relationships, the Board believes that limits could be imposed on shifts of correspondent accounts or the size of the accounts not justified by services rendered. In addition, we believe that a requirement for no preferential treatment should be imposed on all bank stock loans whether or not a correspondent balance exists. Such requirements should be backed up with civil penalties and the Committee may wish to consider the desirability of such a provision in conjunction with the aforementioned margin requirement as an alternative to the prohibitions of Title VIII.

The bill, however, would also reach "outside directors" and will prevent credit-worthy loans by banks which have correspondent relationships with the bank on whose board they sit. It must be remembered that in many instances a correspondent bank is in the best position to judge the credit of people in a downstream correspondent. In view of the restrictions proposed in Title I relating to insiders borrowing from their own institutions, the provision is overly broad and would unfairly restrict the ability of these individuals to obtain credit.

The Board, therefore, believes that outside directors, that is, directors who are not otherwise officers or 10 per cent shareholders, should be removed from the prohibitions of Title VIII and that only the requirement of nonpreferential treatment be instituted with respect to loans to such individuals. That is, the loans should be required to be on no more favorable terms and present no more risk of collectability than comparable loans to third parties.

As it has in the past, the Board favors enactment of a right to financial privacy bill and one which would, as would Title XI, extend the disclosure prohibition to any person rather than just covering disclosure to governmental agencies. We are somewhat concerned, however, that there may be certain technical details in this bill which would impede the Board's ability to carry out its statutory functions.

Section 1110(e) should be amended to make it clear that the title does not authorize withholding of financial information which regulatory agencies have a statutory right to collect whether or not a statute specifically requires the information to be reported. Furthermore, we believe that 1110(b) should be amended to include not only supervisory but also monetary and regulatory functions.

Section 1109 could have the unintended effect of disabling the bank supervisory agencies from exchanging information between themelves or from making relevant information available to the Department of Justice and the Securities Exchange Commission for enforcement purposes.

We therefore believe that a sentence should be added at the end of 1109 which states:

> Nothing in this title prohibits any supervisory agency from exchanging examination reports or other information with another supervisory agency, or from supplying information to a prosecutorial or enforcement agency concerning a possible violation of a regulation or statute administered by the supervisory agency.

We are concerned, however, with section 1104 of the bill relating to the nonauthorized use of terminals and disclosure of a customer's transactions at those terminals. While the Board is generally in favor of such precautions, we believe that this portion of the bill is overly vague. Any provisions relating to EFTS security should set forth standards and methods of security with great specificity in order to enable financial institutions to properly comply with the section. For this reason, we recommend that this section of the bill be deleted so that it may be later considered in greater detail.

The title of the bill relating to holding companies incorporates a number of provisions which were embodied in S. 71 that would improve the Board's supervisory authority over bank holding companies and the Board urges the immediate enactment of these. In addition, this title would authorize the waiver of the 30-day notice requirement in the Bank Holding Company Act in the case of emergency or failing bank situations. The Board believes that enactment of this provision is extremely important and, while it was not incorporated in S. 71, the Board believes it to be completely noncontroversial and recommends its immediate enactment.

Section 1307 of the title would require the Board to promulgate regulations requiring that each bank holding company and its banking subsidiaries include on its board a "reasonable" number of persons who are not affiliated with the holding company or its subsidiaries. The Board believes such a provision preempts the prerogative of shareholders under both national and State law. To our knowledge such a requirement is without precedent and we are aware of no showing of a compelling need to interfere with the rights of shareholders in this regard.

Title XIII of the bill also contains, in sections 1308 through 1313, provisions which would drastically alter the present regulatory scheme for bank holding companies contained in the Bank Holding Company Act of 1956, as amended. As I noted in my introduction, the Board is quite concerned that, due to the size and complexity of H.R. 9086 and the number of important issues covered therein, adequate consideration may not be given as to the desirability of these amendments.

The amendments would prohibit any bank acquisition by a bank holding company if it would result in the bank holding company holding more than 20 per cent of the total assets held by all banks and bank holding companies in the State in which the bank is located. We seriously question the desirability of such a rigid asset limitation and do not believe any need has been shown to impose such a limitation. Recent studies have shown no trend, on a nationwide basis, toward increased concentration during 1968 through 1975. In fact, aggregate concentration declined. Further, during the period 1960 through 1974 there was no overall trend toward increased Statewide concentration.

As a general matter, a requirement of this nature could lead to an anticompetitive market protection for some banks. Furthermore, as drafted, the limitation might have inequitable results between various banking organizations depending on whether the assets were inter-State or intra-State or perhaps derived from an international business, or State deposits, which may fluctuate. The focus on the total assets approach also overlooks the impact of present and future bank-type authority granted nonbank financial intermediaries that might intensify competition to commercial banks for some banking services.

Further, no single percentage figure would be appropriate for all the States due to a number of factors, including, among others, the number of bank and nonbank competitors, competition from out-of-State institutions, the existing size distribution of competitors, the recent history of bank expansion, and legal or economic impediments to unrestrained competition such as home office protection laws. The provision further interferes with the right of a State to determine the desirable banking structure for that State.

We note, however, that section 1308 would allow the Board to deny a bank acquisition which was not in the public interest even though the anticompetitive effects of the acquisition would not rise to the level of a violation of the antitrust laws. We believe that this would constitute a desirable clarification of existing law.

The bill also makes numerous changes in section 4(c)(8) of the Bank Holding Company Act. A number of these changes are consistent with present Board practices or make minor changes in emphasis which would have no substantial effect on the administration of the Act. We would note, however, that the proposed revised standards delete the provision of present law that permits the Board to differentiate between activities undertaken de novo and activities commenced by the acquisition of a going concern. We believe the authority to encourage de novo acquisitions has promoted competition and we strongly recommend that it be retained.

The Board is quite concerned with the requirement that a non-bank activity be not only closely related to banking, but also "directly" related and that it be not only a proper incident thereto, but a "necessary" incident. All of the nonbanking activities presently permitted by the Board were carefully considered under the guidance furnished by the legislative history of the 1970 amendments and after obtaining extensive public comment. A major change in the standards for permissible activities such as that contemplated in section 1309 should only be based on substantial factual evidence that the change is needed. The Board's staff is currently preparing a rather comprehensive study and review of bank holding company activity which would assist in determining whether any change in the present standards for permissible activities would be in the public interest. We believe a major change such as suggested in section 1310 should await the outcome of this study and other factual evidence.

The Board believes that section 1311 of the bill relating to "sound and competitive financing of nonbanking activities" is generally consistent with existing Board authority and practices under the Bank Holding Company Act. We do, however, object to the requirement that intercompany transaction reports be made available to the public, as these reports contain sensitive information comparable in some respects to bank examination reports.

The Board strongly objects to the additional hearing and administrative procedures contained in section 1312 et seq. The Board's present procedures under the Bank Holding Company Act are consistent with the Administrative Procedure Act and provide for an adjudicative hearing on individual applications when there are disputed questions of fact. Section 1312 would depart from the Administrative Procedure Act by requiring a formal hearing for the promulgation of regulations and all individual case determinations whether or not there are factual matters in controversy.

The courts and other authorities on administrative law have long recognized the distinction established by the Administrative Procedure Act between rulemaking and adjudication. Adjudication and a formal hearing are required to determine facts about particular parties, their activities, businesses and property. On the other hand, a rulemaking proceeding is less formal because typically the issues do not relate to evidentiary facts as to which the veracity and demeanor of witnesses would be important. We believe that the precedents in administrative law demonstrate that the public interest is safeguarded and best served by avoiding the cumbersome procedures of formal adversary hearings. In connection with rulemaking, the experience of those few agencies who use formal hearings is that such rulemaking proceedings are unreasonably lengthy. Accordingly, we believe that the Board's present procedures should be continued.

Finally, we are concerned with the provisions requiring the Board to process a petition to commence a proceeding to consider the issuance, amendment or repeal of any order or regulation relating to nonbank activities. We note that under the Administrative Procedure Act there is a present right for any person to petition the Board for the adoption or amendment of a regulation. Additionally, the Board recognizes its responsibility to continually review its regulations and supervise on an ongoing basis the operation of nonbank activities by bank holding companies. However, we believe that the procedure established to challenge the operation of individual companies provides a continuing possibility of collateral attacks on a bank holding company wishing to engage in a bank-related activity. The continuing possibility of unfounded attacks could deter many bank holding companies from engaging in nonbanking activities. This in turn would result in the curtailment of the possible benefits obtained under the Bank Holding Company Act from more innovative and competitive services in bank-related fields.

In conclusion, Mr. Chairman, I would again like to emphasize that the Board believes that the provisions of H.R. 9086 which were originally embodied in S. 71 are constructive and necessary. We commend the Committee on having included them in this bill and recommend their immediate adoption. While the Board is in sympathy with a number of objectives of the additional provisions and might support modified versions of some of the proposals, we believe extensive study should establish the necessity and desirability of any additional legislation. The Board would be happy to cooperate with and assist the Committee in any such study it may wish to undertake.