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STATEMENT

by

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of the

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

on

S. 71, S. 73, S. 895, and S. 1433

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Mr. Chairman. I appreciate the opportunity to testify before this Committee for the Board of Governors on S. 71, S. 73, S. 895, and S. 1433. These bills contain many needed and appropriate measures. Their timely enactment in this Congress will aid the regulatory agencies in carrying out supervisory responsibilities. As you know, many of the provisions contained in the bills parallel recommendations made by the Board and result from the experience gained by the regulatory agencies in recent years.

S. 71, a bill similar to S. 2304 which your Committee dealt with in the 94th Congress, proposes that violations of various banking laws be subject to civil penalties in some circumstances where present law carries no penalty provisions at all, or requires a finding of criminal intent, a difficult procedure. S. 71 also restricts insiders in their dealings with banks and improves the regulatory agencies' power to take remedial action.

To both emphasize and summarize the Board's support of S. 71, I am attaching a bibliography of testimony and recommendations previously submitted to this Committee and the Congress. My detailed comments today will address only those measures that the Board recommends that the Committee incorporate in the bill as now drawn. While all of these proposls for legislative improvement were an outgrowth of reviews by the Board and the other banking agencies undertaken to determine if there were some practicable new measures that could increase the effectiveness of remedial supervisory action, the Board has been very conscious of the need to achieve this result without unduly interfering with the effective conduct of banking business.

For example, in limiting insider transactions, the Board believes that its amended proposal contained in Section 203 of the revised recommendations submitted to the Committee on January 31 is preferable to the amendment to Section 22 contained in Section 3 of S. 71. The Board concluded, as explained in our letter to the Chairman of June 2, 1976, that the original suggestion for restrictions on insider transactions could have adverse effects on the availability of qualified directors for banks in smaller communities and also on the availability of credit in such communities. These adverse effects could be avoided if the revised restrictions on loans to one borrower in Section 22 were not made applicable to outside directors who do not hold more than 10 per cent of the voting stock of a bank. It is unlikely that such outside directors would be in a position to induce the bank to make questionable loans, particularly in view of the liability to which the other directors would become subject. The revised amendment would continue to require the aggregation of loans to officers and also of loans to 10 per cent stockholders and companies controlled by them in applying the limit on loans to a single borrower.

At the same time the Board recommended other changes that we believe would serve to strengthen the authorities' control over transactions that are more susceptible to insider abuses. We propose that specific approval of two-thirds of the entire Board of Directors be required, with the interested party abstaining, before a loan could be made to a director or more than 10 per cent stockholder or to any company controlled by such person where the amount of all such loans exceeds $25,000. In the case of officers and companies controlled by an officer, approval of two-thirds of the directors also would be required for amounts aggregating more than $15,000. We also recommend that Section 22 provide that any such loan be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons.

The Board believes that these revised provisions, coupled with the proposal in S. 71 to provide civil penalties for violations of Section 22 of the Federal Reserve Act, will effectively contain the risk of insider abuse.

Certain other changes in the provisions of S. 71 suggested in the Board's revised proposal were not included in Senator Proxmire's amendment no. 196. I would like to call attention to those that are of particular importance to the Board and urge their inclusion in S. 71.

The Board believes that the requirements for the issuance of a temporary cease and desist order should be broadened enough to include circumstances where the perceived violations of law and unsafe and unsound practices threaten not only insolvency or substantial dissipation of the assets or earnings of a bank or bank holding company, but also a serious weakening of the condition of the bank or bank holding company. We also believe that the standard for judicial review of such orders should be made clear so that a court may enjoin a temporary cease and desist order only where the agency's issuance of such order was arbitrary and capricious. A similar clarification should be made to section 8(f), the judicial review provisions for suspension of officers or directors from office pending administrative removal action under section 8(e).

The Board also believes that a need exists for extension of the Board's removal powers under the Act to officers and directors of bank holding companies and their nonbank subsidiaries and Edge Act and Agreement Corporations. The Federal Reserve should have explicit authority to issue subpoenas in connection with hearings and investigations under the Bank Holding Company Act, and the authority to assess civil money penalties for failure of bank holding companies to file reports required under the Act. I want to stress that the Board's ability to investigate possible violations or evasions of the Bank Holding Company Act and to police effectively the requirements of the Act is seriously hampered by the lack of this explicit subpoena authority.

Although not suggested in our revised proposal, we believe that it would be desirable to make the divestiture authority in Section 4 of S. 71 applicable to bank as well as nonbank subsidiaries as originally suggested. In many instances, the subsidiary bank represents only a small part of the holding company's interests. In such cases, divestiture of the bank would be the most efficient and simplest method of preventing the unsatisfactory condition of the holding company's nonbank subsidiaries from impairing the condition of the bank.

I also want to comment on amendment no. 155 which has been proposed by Senator Tower. The Board has carefully studied this amendment which would institute certain additional due process requirements when supervising agencies exercise removal authority over officers and directors of insured banks. We believe that the Board's revised proposal already satisfies the requirements of due process.

Personal dishonesty must now be proven in a removal action. Senator Tower's amendment would to a large extent continue this requirement. Experience has shown that it is extremely difficult to establish evidence of dishonesty. More importantly, it is too narrow a criteria because the abuse of banks more frequently occurs through the gross negligence or the continuing disregard for sound operations. Thus, we believe the authority for suspension and removal should be broadened as we proposed to include serious charges such as these, whether or not such conduct stems from a violation of a cease and desist order.

Further, S. 71 and the Board's revised proposal provide for the assessment (after notice and opportunity for submission of views) of civil money penalties for violations of various provisions of the Bank Holding Company Act, and orders issued under the Financial Institutions Supervisory Act and the Federal Reserve Act. The assessment of penalties would be subject to *de novo* review in an appropriate United States district court, and the Board believes that its proposals should be altered to include a formal hearing held in accordance with the Administrative Procedure Act. Such an amendment would result in less burden on the judiciary (which would review the administrative decision on the substantial evidence test rather than by a trial *de novo*) and would avoid the delays and other difficulties associated with a collection suit by the United States Department of Justice, especially in those cases where the assessment is not of substantial size. The administrative imposition system proposed by the Board would conform to the recommendation of the Administrative Conference of the United States.

The Board also suggests that the Committee consider as additions to S. 71 some other provisions in the draft bill submitted to the Committee last January. Title 1 of that proposal would provide for a Federal Bank Examination Council along the lines of S. 3494, introduced by Senator Stevenson in the 94th Congress, and consistent with suggestions made by the Board in testinomy before your Committee in December 1975. The Council would establish uniform standards, procedures, and reporting forms for the examination of banks to be employed by each of the Federal banking agencies; establish and conduct schools for bank examiners; and develop uniform reporting systems for banks, bank holding companies and nonbank subsidiaries. It seems particularly appropriate to establish such a Council now in a period of improving liquidity and general strengthening of banking institutions, and coordinate the advances in procedure and technology that have been developed by the individual banking agencies as a result of the experience of the last few years.

The existing informal nonstatutory coordinating committee has provided an effective forum for consultation primarily on interest rate ceilings applicable to savings and time accounts of banks and savings and loan associations and on related policy issues. However, we do not believe that it is desirable to use the coordinating committee mechanism for a Federal Bank Examination Council because both the membership and subjects to be considered would be different. The Federal Home Loan Bank Board is now a member of the Coordinating Committee and the Administrator of Federal Credit Unions may be added to its membership. The Bank Examination Council should be limited to the Federal banking agencies, and should include some degree of participation by the State banking departments so that attention can be concentrated on the unique problems of bank examinations, bank reports and the training of bank examiners. A new undertaking of this kind would be significantly assisted by statutory authorization.

The Board also suggests that this period of strengthening in the banking system affords the opportunity for an objective assessment of the need for emergency takeover provisions such as those contained in S. 890, introduced at the Board's request in the 94th Congress and contained in Section 301(b) to (d) of the Board's attached draft bill. In the last Congress your Committee approved the elimination of the 30-day notice requirement in Section 3(b) of the Bank Holding Company Act when the Board finds that an emergency situation exists or that immediate action is necessary to prevent the probable failure of the bank or bank holding company involved in the proposed acquisition. We urge you to take similar action this year. The Board also recommends serious consideration be given to the provisions in Section 301(d) to allow a large failing bank to be acquired in carefully controlled circumstances by an out-of-State holding company. In the last several years, there have been some instances requiring sales of a failing bank when the communities involved might have been better served if an emergency interstate acquisition procedure of this kind had been available.

Turning to S. 73, a bill to prohibit interlocking management and director relationships between depository institutions, the Board continues to urge enactment of this proposal with the technical modification noted in our report of February 4, 1977.

Let me briefly comment on the Board's involvement in this subject. In 1970, as a result of a request from the Congress, the Board made a special review of interlocking personnel relationships in all of the Federal Reserve districts and also considered the adequacy of the present provisions of Section 8 of the Clayton Act affecting interlocking relationships. As a result of this extensive review the Board concluded that it would be desirable to make several changes in the existing interlock provisions.

The Board communicated the results of its study to the Congress in 1970, and in each of its annual reports thereafter has included a recommendation that these interlocking relationship prohibitions should be revised. Last year Chairman Proxmire requested the Board to draft appropriate amendments to implement these recommendations. This resulted in our proposal of a bill substantively the same as S. 73.

Although interlocking directorates are not necessarily harmful, such relationships between institutions that compete for the funds of the public involve a risk of abuse that the Board believes outweighs any reasonable expectation of benefits. We believe this reasoning applies equally to relationships between all institutions engaged in the business of receiving deposits that may be in competition with each other, including member banks, nonmember banks, savings and loan associations, savings banks, industrial banks, credit unions, or other similar institutions, whether or not their deposits are insured by a Federal agency. Accordingly, the provisions of S. 73 would extend the interlock prohibitions to all such depository institutions.

In order to simplify the test of determining which institutions are to be covered by the prohibition, now specified as being institutions in the same or adjacent communities, the bill would provide that interlocks would be prohibited between institutions located in either the same standard metropolitan statistical area, or within fifty miles of each other. Since there is also a likelihood of nationwide competition for large commercial accounts between very large institutions, this limitation would be supplemented by a nationwide prohibition against an interlock between an institution exceeding $1 billion in total assets, and another exceeding $500 million in total assets.

Provisions are also included in S. 73, Section 2(c)(ii)), to continue the exemption for institutions under common control but in such a form as to prevent evasion of the prohibitions by such a device as the exchange of a few shares of stock between majority shareholders of two separate institutions.

In one instance, the draft would make the present law less restrictive by prohibiting interlocking service by an employee or officer only if he performs management functions for one of the institutions. Employee interlocks involving those who do not perform management functions do not present a significant potential for diminishing competition.

Although we do not believe that detailed regulations will be necessary, general regulatory authority is proposed to be given to the Board as a precautionary matter to prevent evasions of the statute. The Board would also be given the authority to authorize some interlocks. We believe there are circumstances such as an interlock between an established institution and a small or newly established depository institution or a minority bank that for a limited period of time might result in an increase rather than an inhibition of competition.

Depository institutions would have five years after the date of enactment to find replacements for individuals who would be prohibited from service under the new legislation. It would seem needlessly disruptive to concentrate the search for qualified individuals in a shorter period of time.

S. 895, amendments to the Federal Deposit Insurance Act, has been introduced by Chairman Proxmire at the request of the Federal Deposit Insurance Corporation. The Board has no comment to make on the proposals in this bill that are of a housekeeping nature and that extend to the Federal Deposit Insurance Corporation authority over foreign branches and investments of nonmember banks comparable to that the Board exercises for member banks.

However, the provisions that would extend FDIC examination and subpoena authority to bank holding companies and subsidiaries of bank holding companies, of which nonmember banks are subsidiaries, amount to a substantive change in the law. The Congress, in enacting the Bank Holding Company Act of 1956, placed the jurisdiction and examination authority over bank holding companies in the Board. In connection with the Bank Holding Company Act Amendments of 1970, the Congress again gave extensive consideration to various proposals for a change in jurisdiction over bank holding companies and reconfirmed the Board's authority. We believe that giving this authority to the FDIC introduces an undesirable duplication in the bank regulatory structure. We see no need for two Federal agencies to examine and supervise the same institution.

Finally, I would like to comment on S. 1433, the "Depository Institutions Conflict of Interest Act." This bill would revise the conflict of interest prohibitions applicable to members of the Board of Directors of the Federal Deposit Insurance Corporation which includes the Comptroller of the Currency and the Board of Governors of the Federal Reserve System and prohibit employment by or investment in a holding company or holding company affiliate of an institution supervised by the agency.

Present law covers only supervised institutions. The revisions would extend such prohibitions to affiliates of supervised institutions. It would also apply similar prohibitions to the members of the Federal Home Loan Bank Board and the Administrator of Federal Credit Unions. These prohibitions would be applicable for a period of two years after leaving government service, whether or not the individual had completed his term of office.

The Board is in complete agreement with the desirability of a specific provision that the employment and investment prohibitions are applicable to affiliates of the supervised institution, as well as the supervised institution itself. This is consistent with the spirit and purpose of the conflict of interest prohibitions.

However, we question whether it is fair to those now in office, or necessary or desirable, in the case of new appointees, to apply these prohibitions against both employment and investment to officials who have served their full terms. With respect to conflicts of interest, under the provisions of section 207 of the United States Criminal Code (18 U.S.C. § 207) it is a criminal offense for any officer or employee of the executive branch to appear at any time in connection with any judicial or other proceeding in which he participated personally and substantially as an officer or employee. That section also prohibits any such officer or employee for one year after the end of his employment from appearing in connection with any such proceeding that was under his official responsibility within a period of one year prior to the termination of such responsibility. In the case of the Board of Governors, these limitations are also contained in Board regulations on limitations on activities of former members and employees of the Board.

In view of these provisions, we doubt the need for the application of new limitations against officials who serve their full term. With respect to these officials, if any additional limitation is imposed we suggest that it should be limited to no more than six months after the end of their terms.

The Board supports Section 7 of the bill to raise to Level I of the executive schedule the position of Chairman of the Board of Governors of the Federal Reserve System, and to Level II the position of the Board Members. The Board's position on this matter was presented in testimony earlier this month by Governor Lilly before the Subcommittee on Employee Ethics and Utilization of the Committee on Post Office and Civil Service of the United States House of Representatives, and I ask that his testimony be made a part of the record of this hearing.

Mr. Chairman, the Board would be pleased to provide any further information or assistance to you and the Committee in your consideration of these bills.

Thank you.

Bibliography of Testimony and Recommendations by the Board of Governors on Strengthening the Supervisory and Regulatory Authority of the Federal Banking Agencies, Establishing the Federal Bank Examination Council, and Expediting Acquisitions of Failing Banks

1. Letter, dated February 19, 1975, from the Board of Governors, transmitting to the Committee on Banking, Housing and Urban Affairs, United States Senate, the Board's proposals with respect to acquisitions of failing banks or bank holding companies.

2. Statement by Governor Robert C. Holland of the Board of Governors, on July 22, 1975, before the Committee on Banking, Housing and Urban Affairs, United States Senate, on S. 890.

3. Letter, dated September 5, 1975, from the Board of Governors, transmitting to the Committee on Banking, Housing and Urban Affairs, United States Senate, the original supervisory proposals submitted on behalf of the three bank regulatory agencies.

4. Statement by Governor Robert C. Holland of the Board of Governors, on December 8, 1975, before the Committee on Banking, Housing and Urban Affairs, United States Senate, concerning the Board's recommendation for the establishment of a Federal Bank Examination Council.

5. Statement by Governor Robert C. Holland of the Board of Governors, on March 26, 1976, before the Committee on Banking, Housing and Urban Affairs, United States Senate, on S. 2304.

6. Letter, dated June 2, 1976, from the Board of Governors, transmitting to the Committee on Banking, Housing and Urban Affairs, United States Senate, the Board's comments on a proposed amendment to the insider lending provisions of S. 2304.

7. Letter, dated January 31, 1977, from the Board of Governors transmitting to the Committee on Banking, Housing and Urban Affairs, United States Senate, the Board's recommendations for the establishment of a Federal Bank Examination Council, the strengthening of the supervisory authority of the Federal banking agencies and the acquisition of failing banks or bank holding companies.