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Statement by

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before the

Committee on Banking, Housing and Urban Affairs

United States Senate

September 26, 1977

I am pleased to appear before the Committee on behalf of the Federal Reserve to assist you in gathering information on banking practices and express the Board's judgment on the need for additional statutory and regulatory safeguards. It is important to have a full and balanced evaluation of this question. We have a great deal of statutory restrictions and regulation levied on domestic depository institutions in this country, and this oversight legislation and regulation is very effective. Further, the Board has proposed, as you know, additions to its regulatory powers for a number of years. This Committee, to its great credit, and the Senate have recently enacted most of the Board's proposals in S. 71. House action on that Supervisory Powers bill is expected soon. The proposals in S. 71 grew out of years of regulatory experience and they will strengthen the agencies' ability to deal with unsafe and unsound banking practices. In addition, the Board is ready to support some other improvements in regulatory powers. But we must not prohibit legitimate practices or crush the vitality of an industry so essential to our economy.

In accordance with the committee's rules, my testimony will consist of summary comments on the series of questions contained in your letters. Detailed answers to the questions also appear in the Appendix to this statement. As the Appendix states we are in the midst of a definitive study, in response to your request, of banking practices related to bank stock loans. All the Federal bank regulators are participating in this work and the study is expected to be completed by December 1. The preliminary data that we have drawn from this study indicate that some loans to purchase more than 10 percent of a bank's stock are made at rates below prime and in amounts in excess of the purchase price of the shares. A study of 163 banks where control changes in 1975 were financed by stock loans, however, shows that no overall deterioration has occurred in the condition of those banks. While these preliminary indications are consistent with Federal Reserve experience, they may be qualified when the complete study is finished.

In discussing bank stock loans, I want to examine the underlying civic and economic benefits that derive from such credit. There are some 14,500 commercial banks in the United States, and almost all of these corporations are small businesses judged by any standard of bank measurement. The larger shareholders are typically successful small businessmen or women or farmers or professionals, including doctors, dentists, lawyers, and their families or heirs. The local market for such bank stock is extremely limited but local ownership is prized as a civic asset. When owners' estates must be settled or retirement plans met, financing that permits local ownership to continue is often essential as with any similar business transaction. Since a bank is prohibited from lending on its own stock, the small banker, as with so much of his regular business transactions, turns first to his city correspondents for assistance. The principal correspondent is most familiar with the bank's affairs, condition, and principals. Further, to gain such a relationship the correspondent has routinely helped the smaller bank with any problem within its capacity and it does it, of course, because the smaller bank is a prime customer. This process clearly improves the marketability of small bank stock, enhances the attractiveness of such stock as an investment and provides for continuity of local ownership.

Violations of law or good procedure can occur in any lending practice and bank stock loans are subject to particular scrutiny in our examiner's instructions because of the difficult evaluation an examiner must make of three troublesome possibilities. First, it is at least a breach of fiduciary duty for a bank official to obtain preferential terms on a bank stock loan by utilizing his bank's deposits in a correspondent bank. Second, bank stock loans can be a vehicle for circumventing branching and holding company restrictions when the purchase of stock by "straw men" acting on behalf of a larger lending bank are financed by that bank. Finally, when an individual finances the purchase or control of a bank, his loan amortization may require that large dividends and salary be paid to him.

Through the examination process, and the requirements surrounding formations of bank holding companies and acquisitions of new banks by bank holding companies, the Federal Reserve has dealt with these problems. As explained in my letter to you of September 7, 1977, which is attached to my testimony, we have taken a number of steps to prevent such problems. These have ranged from Chairman Burns'1970 letter to the chief executive officer of each State-member bank setting forth the view of the Justice Department that the use of interbank deposits as compensating balances for loans to individuals could constitute a violation of criminal law, to the referral to the Justice Department or U.S. Attorney of 37 cases of possible misapplication of bank funds through loans to officers of other banks and loans on bank stock.

We have sufficient supervisory and regulatory powers to deal with "straw men" and excessive dividends and salaries but the correspondent balance issue is more difficult. None of the cases we have referred to the Justice Department have been prosecuted. Because of the nature of correspondent accounts, it is extremely difficult to prove that there has been a misapplication of bank funds connected with loans to officers or controlling shareholders of a smaller bank and in most cases there has probably been no violation. But alternative approaches clearly deserve consideration by the Committee to prevent real abuses and I will submit Board recommendations covering disclosure and margin requirements and the requirement that bank stock loans be made at market rates and terms responding to three of the suggestions made in paragraph I. G. of your outline.

As the statement in the Appendix indicates, the regulatory authorities have adequate supervisory powers to deal with the subject of "preferential treatment." Competition for profitable bank business is no less common than competition in all other types of business. Legitimate and effective marketing strategy guides banks in offering as many services as possible to customers. The prime rate is offered to the most creditworthy borrowers that maintain relationships that the bank finds most profitable. Plans offering group rates for banking services to the employees as well as the officers of large business customers of banks are just as normal as benefits employees, as a group, may obtain from a group insurance contract with an insurance firm. There is no reason to "curb" such normal banking practices, and the term "favored customer" needs very careful definition if it is meant to imply practices that are harmful to the bank or the economy.

As the Appendix indicates, a small survey of commercial bank overdrafts at 41 State member banks indicates that only eight such banks had overdrafts outstanding to officers, directors and major shareholders, and the aggregate amount of such overdrafts was less than 2/10ths of 1 per cent of the total overdrafts reported by the same banks. Overdraft practices varied at the banks. Eight had fairly liberal standards but we found no evidence in that preliminary study that the application of overdraft policies could be termed discriminatory.

Under Section 22g of the Federal Reserve Act, which imposes ceilings on loans to executive officers, overdrafts are considered to be unsecured extensions of credit and limited by that regulation to $5,000 for an executive officer. We believe there are sufficient bank regulatory procedures in place to administer proper oversight of overdraft policies and practices at banks. However, the

Federal Deposit Insurance Corporation is making a more comprehensive survey of overdraft policies at selected banks and we will, of course, carefully review the results of that study before expressing a final conclusion on that subject. It is our oversight experience that the majority of banks conscientiously endeavor to comply with applicable banking laws and regulations.

Earlier this year at hearings before House Committees, we testified that the General Accounting Office study on Federal Bank Supervision quite correctly pointed out that the majority of violations of law and regulations uncovered by bank examiners were of a technical nature and had little or no impact on the financial soundness of the institution. This is entirely germane to your inquiry about the extent to which banks comply with appropriate law and regulation. As the Appendix indicates in providing specific answers to your questions about violations of provisions limiting loans to executive officers and requiring disclosure of loans from other banks, we are confident that the provisions of S. 71 will provide the base for even better compliance in the future. The payment of insurance premiums to bank officials on credit related health and life insurance arising from credit extensions is covered in detail in the Appendix.

This is a common practice of smaller, rural banks, especially in the mid-West, and particularly in States that have statutes and regulations that prohibit banks from receiving such insurance commissions. The Board's staff is engaged in a detailed study and evaluation of the merits and difficulty of such procedures. On the one hand, the practice permits small banks to supplement salaries and attract more competent management. In addition, such premium income frequently assists in servicing and retiring bank stock loans that are not criticizable. On the other hand, it appears to be a diversion of income from the bank. I cannot report that the Board has taken a position on this practice generally, but it has carefully administered the provisions on S. 106(b) of the Bank Holding Company Act to assure that no impermissible tie-in provisions are present in bank lending practices. Further, we have no evidence that unsound loans are made by member banks in an effort to generate insurance income. This would be a self-defeating practice in that bad loans could have a serious impact on an institution many times larger than the mere receipt of insurance commissions.

I have included in the Appendix a complete list of 35 orders and agreements executed by the Board during the last five years under the powers granted in the Financial Institutions Supervisory Act of 1966 In addition, 14 agreements have been entered into by Reserve Banks and State member banks during this period.

There are specific and sufficient laws covering directors' liability for improper banking practices. In addition, directors receiving excessive salaries or dividends or misusing bank assets are subject to proceedings under the Financial Institutions Supervisory Act since such practices would appear to constitute "unsound banking practice". The Board has taken action to terminate excessive salaries and dividends paid to a director and controlling shareholder by a bank holding company. These same conditions would most probably invite civil suit by other corporate shareholders as well.

I want to point out also that two of the Board proposals incorporated in S. 71 will clarify the Board's authority to issue cease and desist orders against individual officers and directors. Further, the criteria for removing an officer or director that is expanded to cover gross negligence in S. 71 will expedite Federal Reserve action in the case of directors who flagrantly ignore their fiduciary responsibilities.

Comments are included in the Appendix citing Title 18 in Section 411(b) of the United States Code which deals with impermissible bank political activities.

While there is no specific prohibition against pledging the same collateral for different loans at different financial institutions, it is our opinion that none is needed. The Uniform Commercial Code with great detail and specificity sets up the rights and priorities between creditors to collateral pledged to secure loans.

I have also provided an answer to your question about the application of conflict of interest regulations affecting examiners who may take positions after their Federal service with banks. The GAO reviewed this question in the study mentioned previously in my testimony and concluded "since few examiners left to work for banks they examined, we see no threat to their objectivity as long as the agencies continue rotating examiners-in-charge among banks examined and review examination reports at regional offices and District banks." Professional bank examiners have in the past been a source of good management talent for the banking industry. They are subject to careful conflicts of interest policy governing any dealings with banks while they are examiners. Their work and recommendations are reviewed by the Federal Reserve Bank senior staff as well as senior Board officials. We do not believe any addition to the current protections is necessary.

The issue of whether or not there should be a Federal statute requiring supervisory approval for the transfer of control of banks has been examined carefully by the Board. Such requirements are presently necessary for the chartering of new banks or the acquisition or control of banks by corporations or partnerships. However, there is no prior approval required of individuals who purchase controlling interests in banks. In the suggestions for new authority that I will send you, we will include a strengthening of disclosure and reporting requirements covering the acquisition of 25 per cent or more of the ownership of a bank by an individual. At present the institution must make such a report, but since it may not be aware of such changes, the Board will recommend that the acquiring shareholder be required to file the disclosure report.

In summary, the complex and comprehensive Federal oversight and regulation of the banking industry has effectively served the public purpose of stopping all but an incredibly small number of bank failures in the United States. No other private industry is subject to such detailed Federal and State financial oversight. This system has evolved and met changing conditions in our economy. I believe the passage of S. 71 is part of this careful development of regulatory restrictions aimed at controlling unsafe and unsound banking practices. I believe some modest additional measures, as indicated in this testimony, will be helpful today. I reject the concept that we need to propose pervasive and severely limiting broader restrictions on banking institutions and their managers. I cannot resist pointing out one anachronism. All of our Federal laws governing banking institutions cover only domestic banks. We have no such Federal oversight for the growing and significant population of foreign banks operating in this country. This Committee in the past has considered such legislation. The House is presently deliberating over an International Banking Act, and I can say categorically that the one area where some form of fair and comparable regulation is needed is that which addresses the powers and oversight of foreign institutions operating in the United States.

Thank you.