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Statement by

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before the

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I appreciate the opportunity to present today the views of the Board of Governors on the results of the survey on bank stock loans, insider loans and overdrafts that was recently conducted for this Committee. The Federal Deposit Insurance Corporation has provided summary data from the survey based on reports from 14,137 banks, representing about 98 per cent of all insured commercial banks. Earlier this week, the three Federal bank supervisory agencies also forwarded to this Committee a joint staff analysis of the survey data. As this comprehensive analysis has been made available to the Committee, I will not review the results of the survey in any detail today. Instead, I want to focus on several of the major findings, including several that are cause for concern.

Before discussing the principal findings, I believe it important to caution that many banks experienced considerable difficulty in filling out the report form. The survey was very broad in scope, was conducted under extraordinarily tight time constraints and did not allow for the careful pretesting that is our standard procedure in survey undertakings. Due to the complexity of the survey questions, much of the information requested was not readily available from central records and had to be retrieved by hand from credit and collateral files. In addition, lack of familiarity with this one-time survey questionnaire undoubtedly caused difficulties in bank interpretations and responses. While very substantial efforts were made to identify and rectify such reporting problems, the Board believes the data to be a good deal lower in quality

than most regularly collected banking data, and has serious reservations about its reliability.

Because of these and other shortcomings of a statistical approach to the subjects covered, the Board believes it is essential to go beyond the survey results before recommending any regulatory or legislative changes. The Federal Reserve plans to conduct promptly a follow-up investigation of those State member banks indicated by the survey returns to have engaged in possibly improper activities. We will be prepared to submit our findings and recommendations to the Congress within 90 days. Meanwhile, the Board continues to support S. 71 as passed by the Senate, as well as the additional provisions of H. R. 9450 introduced in October, 1977, by Congressman Allen. Among those provisions are restrictions on extensions of credit to insiders, including insiders at correspondent banks.

However, I am prepared to convey today the Board's preliminary reaction to the contents of the survey. In general, while the results raise questions about potential insider abuses, these dubious practices do not appear to be widespread or to involve quantitatively large commitments of available funds. Indeed, the aggregate dollar amount of the types of loans covered in the survey (bank stock loans, loans to insiders of the reporting bank and loans to insiders of other banks) represents only about 3 per cent of the total loans at domestic offices of all commercial banks. In addition, it appears that the great majority of each of these three types of loans were made on something close to

standard commercial terms, as indicated by the finding that over 90 per cent of each type of loan carried interest rates at or above prime.

Moreover, it should be remembered that important and legitimate economic functions are served by most of the lending activities covered by the survey. Bank stock loans provide the means for the orderly transfer of bank ownership, especially in unit or limited branching states where nearly three-fourths of such loans were made. Loans collateralized by bank stock also represent a significant source of funding to augment bank capital. And although nearly 90 per cent of the credit extended to insiders at the reporting bank represented loans to directors and their business interests, the vast majority of these loans probably represent normal commercial credits to customers ranking among the bank's best.

I would like to consider each of the four parts of the survey, review the potential problem areas that they addressed and discuss the Federal Reserve System's approach to dealing with these problems.

The first part of the survey focused on loans secured by bank or bank holding company stock. The primary objective was to determine whether insiders may have used the correspondent balance of their banks in order to obtain bank stock loans from other banks, possibly at preferential rates. Banks were asked to report data on each loan with a current balance of $25,000 or more if the lending bank held in the aggregate as collateral 10 per cent or more of the outstanding voting shares of the banking organization whose stock was pledged on the loan. Less than 6-1/2 per cent of the banks reported having such loans, and

most of the loans reported were made by the larger regional and money center correspondent banks. About four-fifths of these loans were made to insiders--that is, executive officers, major shareholders, or directors--of the bank or bank holding company whose stock was pledged.

The survey results raise the possibility of some insider abuse connected with bank stock loans. In 88 per cent of the reported loans, the bank whose stock was pledged maintained a demand balance with the lending bank. Of course, the correspondent relationship may have been long established, predating the bank stock loan, or might have been entered into for reasons having nothing to do with the loan. In addition, the survey data indicate that insiders of other banks typically obtained lower rates on their bank stock loans when a correspondent balance was maintained with the lending bank. The interest rate on bank stock loans was above 8 per cent on only one-fifth of the fixed rate loans where balances were maintained, compared with more than one-half of such loans where balances were not present. Similarly, the interest rate was below 7 per cent on 46 per cent of loans when balances were maintained compared with only 18 per cent when there were no such balances.

It is important to recognize, nevertheless, that the data do not provide conclusive evidence of more favorable treatment. The rate of interest is only one among several important terms and conditions of a credit transaction. Data on other factors such as origination date of the loan, the maturity of the loan, the creditworthiness of the borrower and the loan to collateral value ratio were not collected

and could account for differences in rates. Moreover, it may be noted that for the bulk of the loans where a balance was maintained, there was no apparent relationship between the interest rate on the loan and the size of the balance. Thus, borrowers apparently did not receive lower rates by having their bank maintain a larger balance. Finally, the survey evidence indicates that bank stock loans were not often negotiated at rates below the prevailing prime rate. For example, during the most recent 1976-77 period, when 85 per cent of the reported loans were originated or rolled over, less than 2 per cent appear to have been made at below the average prime rate.

The second part of the survey dealt with all types of bank loans in excess of $10,000 (including mortgage loans of over $60,000), to insiders of other banks. Again, the primary objective was to determine whether insiders may have used the correspondent balances of their banks in order to obtain loans from other banks, perhaps on more favorable terms. The evidence suggests that lower rates were sometimes received by these insiders when their banks maintained balances with the lending bank. For example, when a demand balance was maintained, the weighted average rate for fixed rate loans was 7.58 per cent, compared with 8.47 per cent for loans when a balance was not maintained. For all reported floating rate loans, when a correspondent balance was maintained the weighted average rate for loans was 7.72 per cent, versus 8.21 per cent for loans without a balance. Again, care must be taken in interpreting these rate comparisons. The differences on average are not particularly

large, and may reflect other factors on which information was not collected as part of the survey.

It should be pointed out that the maintenance of correspondent balances is a necessary, long established practice in the banking system that ordinarily represents a mutually beneficial arrangement for the banks involved. For example, smaller banks typically maintain demand balances with regional or money center correspondents to compensate the latter for the provision of a wide variety of services such as check clearing, deposit accounting and investment advice. Given a continuing close relationship of this nature between banking organizations, which generally necessitates frequent contact between their senior personnel, it is only natural for officials of the smaller bank to seek accommodation at the correspondent bank. The correspondent's lending officers typically will know the borrower very well, and in those cases where the stock of the smaller bank is pledged, they will be familiar with the condition of the bank.

Nonetheless, the Board has recognized for some time the possibility of abuse in the placement of correspondent balances and has taken a number of measures to limit such abuse. As you know, the Federal Reserve received a letter in September, 1970, from the Justice Department citing the inappropriate use of correspondent balances for the personal benefit of bank officials. The views of the Justice Department and the concern of the Board of Governors on this matter were conveyed to each State member bank in a letter from Chairman Burns on October 26, 1970. It was indicated that the practice of using interbank

deposits as compensating balances for loans to individuals connected with the depositing bank could warrant prosecution in certain situations.

Since 1967, the Federal supervisory agencies have been exchanging information developed during examinations on loans to officers of other banks and loans secured by stock of other banks. All reports of loans to officers of State member banks received from the other agencies are verified at subsequent examinations of the banks where the officers are employed to determine compliance with Section 22(g) of the Federal Reserve Act and the Board's Regulation O. The examiners were further instructed in 1973 to expand their verification of these reports to include, among other things, a determination of whether more favorable interest rates were being obtained and whether correspondent balances held with the lending bank were commensurate with the services provided.

Our concern about potential abuses in the granting of bank stock loans or loans to executive officers also has been reflected in several public statements issued in connection with bank holding company applications. In each application for approval to form a bank holding company or to acquire an additional subsidiary bank, the Board requires disclosure of any indebtedness collateralized by the bank's stock, including an indication of any changes in correspondent balances or a description of any agreement or understanding concerning correspondent balances. The purpose of this requirement is to determine whether bank credit is being obtained on a basis that encourages or rewards the improper use of interbank deposits. The Board considers the existence

of more favorable loan terms in connection with the placement of a bank's correspondent account as an adverse managerial and banking factor in acting on holding company cases.

Similar disclosure is required in the annual reports that bank holding companies must submit to the Board. All of this information is reviewed and taken into consideration by the Federal Reserve in its regulatory and supervisory actions regarding bank holding companies. In some instances, we have been able to detect and to eliminate preferential interest rates on loans collateralized by bank stock. However, the determination of abuse regarding correspondent balances is more difficult in view of the numerous services that can be rendered to justify the balances.

The third part of the survey dealt with loans by banks to their own insiders. The primary objective was to determine whether insiders may have received preferential rates. Banks reported $10 billion of such loans, of which nine-tenths had been made to directors of the bank or their business interests. It is difficult to interpret the significance of this finding because bank directors are frequently recruited from among a bank's best customers. Thus, a loan relationship with a director's outside business may well predate his appointment to the bank's board. In other words, a substantial proportion of these loans probably would have been made regardless of any "insider" relationship.

The survey results show that the average rates paid by insiders were generally above the prime rate, that is, the rate charged by large banks to their most creditworthy customers. For example, for the fixed

rate loans made to insiders at the reporting bank during the third quarter of 1977, the average rate was 8.07 per cent, compared to an average prime rate during that quarter of 6.90 per cent. On fixed rate loans made to insiders during the first half of 1977, the average insider rate was 8.29 per cent, well above the average prime rate of 6.36 per cent. The average insider rate was significantly below the average prime rate only for loans originated in 1974. This was an abnormal year in that the prime rate rose precipitously during the year to a record high. Many smaller banks do not closely follow the large bank prime rate in pricing their loans, which could account for some of the reported loans having been made at rates below prime in that year.

In the Board's view, the survey data do not seem to suggest any widespread abuse involving insider loans. In part, this may reflect enforcement efforts under Section 22 of the Federal Reserve Act, which places tight limitations on the types and amount of loans a member bank can make to its own executive officers, and prohibits terms on such loans that are more favorable than those afforded other borrowers. Last year, the Senate approved legislation that would extend and strengthen the restrictions of Section 22. One of the provisions adopted in S. 71 would prohibit a commercial bank from making a loan to any officer, director or 10 per cent shareholder, or to any company controlled by such parties, unless such loan was made on substantially the same terms as those prevailing for comparable transactions with other persons. In addition, such insider loans could not involve more than normal credit

risk, and could not contain other features unfavorable to the bank. As you know, the Board strongly supported S. 71 and hopes that it will be enacted by the Congress this year. Such legislation should go far in protecting banks from abuse from insider lending.

The final part of the survey dealt with overdrafts by insiders of the reporting bank, insiders of other banks and public officials. The objective was to determine whether there were significant abuses associated with these overdrafts. The survey showed that two-thirds of the reporting banks had no overdrafts exceeding $500 to any of their own insiders at any time during the first nine months of 1977. More than 90 per cent of the banks had no overdrafts over $500 during that period to insiders of other banks or to public officials.

However, two findings deserve comment. First, there were reports of isolated cases of very large overdrafts, mostly to insiders of the reporting bank. These overdrafts may have been of very short duration or may have been offset by other accounts held at that bank, but they deserve further investigation. Second, a large proportion of the banks reporting overdrafts to their insiders indicated that they always or frequently waive overdraft charges. The fact that charges are waived much more frequently for insiders of the reporting bank than for insiders of other banks and public officials suggests also that there is a more favorable treatment of the former group than of the general public.

It should be noted that overdrafts are considered to be unsecured extensions of credit and are included in the limits on loans to executive

officers of member banks under Section 22(g) of the Federal Reserve Act. Such loans are limited to a maximum of $5,000. We will, of course, take into account these survey results in order to ensure in the course of our examinations that there is full compliance with this statute.

In summary, the survey findings do not appear to indicate any pervasive pattern of more favorable treatment for insiders at commercial banks. The real possibility of a significant incidence of questionable practices, however, has been brought to light. These will have to be considered carefully on a case-by-case, bank-by-bank basis before any firm conclusion of abuse is warranted. But if the suggestion of improper practice is validated, supervisory action will be taken. Such action, scaled appropriately to the indicated violation, could be more readily and flexible applied if S. 71 were to become law.

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