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Statement by

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before the

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I appreciate the opportunity to participate in these hearings, which seek ways to strengthen our financial system and the economy that it supports.

We at the Federal Reserve welcome this inquiry, and want to be as helpful as we can. Among the variety of proposals before you, there are some which would alter established patterns of doing business--not just for banks or other financial institutions, but also for business firms of all kinds, in small towns as well as major financial centers. Before you act on these proposals you will need to know a good deal about these existing business relationships, in order to assess the consequences, good and bad, of changing them. In testifying for the Board, I am very much aware of the limits of our knowledge about these relationships. Therefore I will not try to comment on all the proposals. Rather, I will offer for your consideration only those judgments that the Board feels reasonably confident are supported by our experience and understanding.

One area with which we are familiar involves interlocks among banks. Section 8 of the Clayton Act deals generally with interlocking relationships and specifically with interlocking bank relationships. The Board is responsible for enforcing section 8 to the extent that it involves member banks of the Federal Reserve System.

Our experience has convinced us that there is nothing inherently wrong about interlocking directorates. On the contrary, corporate boards of directors should be composed of men having diverse backgrounds, so that the corporations they serve may benefit from their ideas and experience. I might add that bankers, because of their broad experience, are especially qualified to serve as directors of other corporations, and this accounts for the fact that many serve in this capacity. The cross-fertilization which director interlocks have provided America's corporations has been manifestly healthy for business and the nation. Public policy, as embodied in the Clayton Act, has recognized this fact. The Clayton Act was designed to prohibit only those interlocks which tend to diminish or eliminate competition. Aside from this salutary prohibition, interlocks are permitted.

In view of the difficulties involved in determining on a case by case basis when banks are in competition with each other, section 8 uses a simple test. Interlocks are prohibited when the two banks are in the same or neighboring cities and towns. In 1935, when this test was adopted, it was believed to be a workable way of confining the restriction on interlocks to those situations where it is really needed to avoid anticompetitive consequences. Generally speaking, the test has worked well over the years.

The risk of thwarting competiton within a city is not confined, however, to interlocks involving member banks. We believe therefore that the prohibition of interlocks should cover all insured commercial banks. Indeed, we believe the prohibition should extend to savings banks and savings and loan associations, as well as commercial banks. There is sufficient overlapping of functions among these institutions to support a general presumption that those in the same or neighboring communities compete with each other.

You may wish, as well, to consider covering institutions whose deposits are not federally insured. Exempting uninsured commercial banks may be of minor importance, since only about 200 banks accounting in the aggregate for less than 1 per cent of total deposits are uninsured. However, about a third of all mutual savings banks and a fourth of all savings and loan associations are uninsured, and they hold about 13 per cent and 3 per cent of their respective total deposits.

While H. R. 5700 would exempt interlocks between banks that are owned by the same company, it would prohibit interlocks between those that are owned by the same individuals--so-called "chain banking." The exemption should apply to both instances, inasmuch as interlocks cannot reduce competition between banks that are already

under common control. Section 8 of the Clayton Act now exempts interlocks between two or more banks where a majority of the common stock is owned by the same persons. We believe a comparable exemption should be written into H. R. 5700.

We also believe that the types of interlocking service that are now prohibited should be reexamined. For member banks, section 8 covers interlocking service as a "director, officer, or employee," whereas for other corporations it applies only to service as a director. It seems needlessly restrictive to cover all employees; we recommend instead that coverage be limited to service as a "director or an officer, or an employee with management functions."

H. R. 5700 would prohibit bank interlocks without regard to the competitive relationship of the banks or their geographic location. The Board recommends, instead, retention of the present geographic test--so that interlocks would be barred only where they involve banks located in the same or adjacent communities--with two exceptions.

First, we recognize that some banks compete in markets that are nationwide. Nationwide competition for both deposits and loans has been increasing and can be expected to increase further in the future. The Board recommends, therefore, that interlocks be prohibited among all banks over a certain size--perhaps $1 billion

in assets--regardless of where they are located. Admittedly, there is an element of arbitrariness in this test, but we think that the alternative of making detailed analyses of competition in various banking markets would be impractical. Provision should perhaps be made for administrative waivers of this prohibition upon a showing by the banks involved that they operate in separate markets. And it could prove useful to grant authority for changes in the $1 billion figure by regulation.

Second, we suggest a variant of the geographic test for holding company banks, namely, interlocks should be prohibited between a holding company or any of its subsidiary banks, wherever located, and any other bank located in or adjacent to any community served by a subsidiary bank.

In weighing the need for the additional restrictions in sections 2 through 10 of H. R. 5700, it should be borne in mind that section 8 of the Clayton Act now prohibits interlocking directorates between corporations engaged in interstate commerce which are "by virtue of their business and location of operation, competitors, so that the elimination of competition by agreement between them would constitute a violation of any of the antitrust laws." It would be helpful if the Congress made it entirely clear that this provision

applies to interlocks between banks and nonbank businesses. Such action would provide ample protection against interlocks where the anticompetitive effects may be significant. In considering further restrictions, Congress should proceed very cautiously so as not to inhibit banks or other corporations--particularly new or smaller ones--in their search for directors of the highest caliber available.

Let me turn now to sections 12 and 13 of H. R. 5700, which relate to the trust departments of insured commercial banks.

Section 13 prohibits a trust department from holding stock issued by the bank itself or its parent holding company. In such situations, if the bank has sole voting rights there is a risk that the stock may be voted to perpetuate the bank's management in office. Where a national bank holds its own stock as sole trustee, it is not permitted under section 5144 of the Revised Statutes to vote that stock in an election of directors unless the "donor or beneficiary actually directs how such shares shall be voted." The essential purpose of the prohibition in section 13 against a bank holding its own stock in its trust department can be better served by extending the provisions of section 5144 to insured State banks.

Section 13 would also prohibit a bank trust department from holding more than 10 per cent of any class of stock registered under the Securities Act of 1933. The Board doubts the wisdom of such a prohibition. Among other difficulties, it would deny individuals with very substantial holdings in the stock of a corporation access to the services of bank trust departments and thereby practically force them to rely on individual fiduciaries. This could cause serious problems for individuals and families that need or want to rely on an institution with a permanent life. Furthermore, if individual bequests naming a bank's trust department as trustee should raise that department's aggregate holdings of some stocks above the 10 per cent limit, this bill would force the trust department to sell off some of such holdings even if it were adverse to the investment interests of the beneficiary to do so.

The argument for the limitation is that bank trust departments hold large blocks of stock in major corporations, and thus could exercise influence over them. However, as the SEC's Institutional Investor Study Report points out, the "existence of potential power on the part of institutions to influence corporate decisions by reason of their substantial shareholdings does not demonstrate that such influence is in fact exercised." (Summary Volume, p. 124) If the

Congress concludes, nonetheless, that a 10-per cent limit is needed, its potentially disruptive effects could be lessened by applying it only to future purchases made at the initiative of the trust department.

Section 12 of the bill would require bank trust departments to disclose annually a list of all securities held (other than Government securities), indicating the name, class, value, and number of each security held, the authority of the trust department to exercise voting rights, and the manner in which it exercised proxies.

In other words, section 12 would require public disclosure of all assets, debt instruments as well as equities, small interests as well as large, without regard to the bank's role in acquiring the assets or its ability to exercise voting power. Such a sweeping requirement would result in the disclosure of interests that could be readily associated with trust customers who would consider such disclosure an invasion of their privacy. As a consequence, much of this business may well be transferred to unregulated trustees. Compilation of the vast array of statistics required would also necessitate changes in procedures that could prove too costly for all but the biggest banks.

It would appear that the objectives of section 12--public disclosure of information needed to assess the impact of bank trust

investments on securities markets and on economic concentration--could be accomplished with a requirement confining disclosure to holdings where the stock is registered under the Securities Exchange Act of 1934, where the trustee has exclusive voting rights, and where the trustee's aggregate holdings of the stock exceed a specified amount, say, $1 million. The Board also recommends that this disclosure requirement apply to all fiduciaries, not only the bank trust departments.

Section 14 of the bill would prohibit banks, other thrift institutions, and insurance companies from accepting any equity participation in consideration of making a loan. "Equity participation" is defined to include two quite different kinds of economic relationships: first, an ownership interest in any property or enterprise; second, a right to any payment which is linked to the income from any property or enterprise. The first relationship is clearly susceptible of speculative abuse; the second may provide a constructive method for adjusting credit charges to changing economic conditions. As recent experience has demonstrated, the second form of financing can in fact facilitate extensions of credit to relatively new firms and real estate developers which typically lack ready access to the public capital markets.

A ban on acquiring of "ownership interests" by banks is not needed, in view of the prohibitions in existing law against bank purchases of

stock. However, banks may--and some do--make loans that provide for a return to the bank that varies according to the income of the property or business financed. Heavy concentration in loans with such variable-return provisions could pose a threat to bank safety. While bank examiners are mindful of this risk, the Congress may deem it prudent to limit the aggregate of loans with such provisions to a specified percentage of a bank's total assets or its capital and surplus.

Section 15 of the bill would require each insured bank to report to the FDIC all loans it makes to any of its directors, trustees, officers, or employees, or their families. It would also prohibit the bank from extending credit to any corporation in which such persons (as a group) have as much as a 5 per cent stock interest. These provisions would change existing banking practices far more than is wise, particularly in small towns. It is quite common and salutary for a bank to include on its board of directors individuals who have substantial interests in business firms in town. These firms are likely to do business with the bank in a number of ways, including borrowing. To force the bank to choose between cutting off credit to such firms and excluding their principal stockholders from its board of directors could result in stagnant towns or weaker banks.

Still, something needs to be done to provide more protection against unsound loans to insiders. One possibility would be to amend the Financial Institutions Supervisory Act of 1966 to make cease-and-desist orders more readily available to stop these practices when they are discovered in the course of bank examinations. We have in mind a provision that would establish a presumption that it is an unsafe and unsound banking practice for a depositary institution to lend to insiders or enterprises controlled by insiders an amount that in the aggregate exceeds a specified percentage of the institution's capital and surplus. If a bank failed to observe this rule the supervisory agency could file a notice of charges, with the bank bearing the burden of establishing that the loans in excess of the limit are safe and sound.

Section 19 of the bill would prohibit insured banks from paying compensation to brokers or others for obtaining deposits for the bank. Brokered deposits at State member banks have not posed serious problems. As of July 31, 1970, according to a survey of State member banks, only 30 out of 1,157 reporting banks held brokered deposits and they amounted to less than 1 per cent of total deposits in those 30 banks. A case can be made that brokers help to channel funds into capital-poor areas. However, in view of the part that loans tied to brokered deposits have played in bank failures in recent years, we are

inclined to agree with those who conclude that the benefits of brokering are outweighed by the dangers, and we therefore support section 19. We recommend against enactment of the criminal sanctions provided in section 21, since we believe the civil penalties provided in section 19 plus other remedies available are sufficient for enforcement purposes. Moreover, section 21 as drafted would seem to prohibit legitimate activities such as paying an employee for bringing in new deposits, whereas section 19 meets this problem by authorizing the FDIC to prescribe regulations, which presumably would exempt such activities.

Sections 25 and 26 provide for full insurance of public deposits in institutions insured by FDIC and FSLIC. The Board is concerned about the impact of these sections on the markets for Federal and municipal obligations. Banks are now generally required to pledge collateral as security for uninsured public deposits. A sizable portion of the Treasury and municipal obligations held by banks is pledged under these collateral requirements. For example, according to the latest survey available (1966), over half of the Treasury obligations held by commercial banks were pledged for this purpose; among larger banks the proportion was even higher. Extending insurance coverage as proposed by H. R. 5700 would reduce the attractiveness of such securities as investments for the banks, and thus tend to raise borrowing costs for the Federal, State, and local governments.

Let me turn now to Mr. Gonzalez' bill, H. R. 3287, which would prohibit any insured bank from making a loan to finance the purchase of stock or obligations of another bank. A flat prohibition of this kind would reduce flows of capital into banking and severely restrict ownership of banks, eliminating potential entry by those who cannot afford to buy bank stock without a bank loan. The Board therefore recommends against enactment of H. R. 3287. Nevertheless, while H. R. 3287 is too restrictive, some additional controls over bank loans on bank stock are needed. We believe Congress should authorize one or more of the regulatory agencies to prescribe regulations applicable to all insured banks, with a view to ensuring that loans made to finance the purchase of bank stock meet sound banking standards and are not used as devices to promote the interests of speculators or the lending bank to the detriment of the purchased banks.

In conclusion, let me say that the Board fully joins this Committee in its efforts to improve the organization of finance in our country. We can and do support numerous provisions of H. R. 5700. We also support the objectives of H. R. 3287. We believe, however, that the legislation before this Committee goes beyond what is necessary to achieve the objectives that their distinguished authors seek to promote.